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PUBLIC FINANCE

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By the same author
HISTORY OF ECONOMIC THOUGHT (2nd Edition)

PUBLIC FINANCE

(For Honours and Postgraduate Students of Indian Universities)

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Fifth Revised Edition

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PREFACE TO THE FIFTH EDITION

This is a thoroughly revised edition in which some theoretical parts have been extensively revised in the light of latest developments while others have been adjusted marginally. Mention may be made of the 'effects of taxation', 'incidence of taxation', 'taxation of capital gains', 'balanced budget as an anti-cyclical instrument', 'deficit financing as a hidden tax' and so on. Similarly, the portion dealing with Indian public finance has been thoroughly revised and updated. The above-mentioned revisions and additions are over and above the ones incorporated till the Fourth Edition.

It is hoped that the book in its present form would be found more useful by the readers.

H.L. Bhatia

PREFACE TO THE FIRST EDITION

Public finance is a subject which has the distinction of intimate interaction between theory and practice. As such it acquires a meaning and usefulness only in the context of institutional framework of the economy with reference to which it is being studied. The theoretical concepts and policy applications in public finance feed upon and grow out of each other. No single theoretical model can adequately fit in the framework of every economy since its institutional framework is a thing unique to itself. It is important, therefore, that the discussion of public finance should be in the context of a single economy. An attempt has been made to satisfy this criterion in the present book. Care has been taken to draw illustrations mainly from the Indian economy and present analysis of the theoretical problems in the context of Indian setting. As our society is committed to a rapid economic growth along with economic justice, there is an undercurrent of 'growth' and 'welfare' considerations in the treatment of the subject.

Public finance is a vast subject and in any book there is inevitably an involved question of the choice of the problems and the relative emphasis accorded to them. In the present context the issue has been resolved with reference to the syllabi of the Indian universities with the hope that this would make the book additionally useful to the students. It is divided into two parts: Part I covers the theory of public finance and Part II covers the field of Indian public finance. The style of the book is a lucid and simple one and an attempt has been made to clarify the nature of the issues involved along with the main body of the argument.

I owe a debt to Dr A.M. Khusro under whose guidance I learnt the use of tools of research. I would also like to express my gratitude to Dr C.B. Gupta, my teacher and Principal, Shri Ram College of Commerce, who has been a constant source of encouragement to me; and to Dr T. Mathew, Chairman, Department of Economics, North-Eastern Hill University, who was deeply interested in seeing this book through.

H.L. Bhatia

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PART 1

THEORY OF PUBLIC FINANCE

1. ECONOMIC ACTIVITIES AND THE STATE

INTRODUCTION

The basic nature of any economy lies in the scarcity of its productive resources in relation to its wants. Our wants are unlimited, or at least keep on increasing and to satisfy all these wants, we need an unlimited supply of productive resources which could provide the necessary goods and services. An economy is constantly engaged in the solution of this eternal problem of scarcity. With this end in view, an economy undertakes various activities whereby the available supply of resources could be augmented, the existing supplies could be utilized more effectively, and the objectives of stability, employment, growth, and distribution etc. could be met with as fully as possible.

Both the public and the private sectors[1] of the economy may be assigned different roles in this total set-up of economic activities. Obviously, the division of the economic activities between the public and the private sectors should not be a haphazard one. The choice should be made in the context of the relevant economic considerations and political and social objectives. In this connection, different societies have evolved different economic systems along with the accompanying sets of economic, political, social and other institutions. Thus, in a *capitalist economy* the main task of providing the goods and services is assigned to the private sector in which each economic unit operates in accordance with economic rationality and is guided in this task by the market mechanism. The market mechanism gives out signals for different economic units to act in specified manners. The owners of the factors of production are guided by the income which they can earn in different employments; the investors are guided by the profitability of different investments; the consumers try to maximize their consumers' surplus, and so on. In this set up, the government has only a limited role to play. A *socialist economy*, on the other hand, is dominated by the State sector. Here economic activities and decisions of the State would not be guided by com-

[1]We are using the term public sector or state sector to cover 'non private' sector and government undertakings would form only a part of this sector.

mercial profitability but by the overall objectives that it has in mind. Market mechanism is assigned, if at all, a very marginal role. In between these two types of economic systems, we have the *mixed economy* where both the private and public sectors appear in sizable proportions. Thus, every economy has to choose between the areas of activities assigned to the private and public sectors. In the latter, the dictates of the State are expected to be followed. Here the economic activities and decisions of the economic units would not be guided by commercial profitability but by the overall objectives that the society has in mind.

It is fairly common on the part of various authors to justify the presence of public sector in the totality of economic activities. For example, some authors would make out a case for increasing State activities on grounds of 'distorted' production and employment patterns. They would tell us that left to itself, the market mechanism may misguide the society whereby some necessities may not be produced in adequate quantities while some luxuries could get a place of prominence. We might get, for example, air-conditioners in the midst of milk scarcity. Another argument in favour of increasing the role of the public sector would be that the market mechanism by itself is not able to bring about adequate level of employment. Keynes was one of the strong advocates of this thesis. According to him, there was always a strong tendency for the aggregate effective demand to fall short of the required amount for producing full employment. So, he advocated repeated doses of public investment. Rooting out the trade cycles provides another rich field of arguments in favour of State action. Yet other authors would want the State to take an active part in accelerating the rate of economic growth and in bringing about a more equitable distribution of income and wealth.

Study of public finance is closely related to the activities of the public sector which, in the extreme case, may consist of only the government undertakings and other government organs. Now we are interested in the study of public finance which is closely related to the activities of the public sector. However, in order to grasp the nature of public finance and the various problems and principles that go with it, it is very helpful to distinguish between the *public* and *private* goods and to look at the corresponding roles of private and public institutions in supplying these goods. This we do in the following paragraphs by discussing the nature of public and private goods.

PUBLIC GOODS* *VS* PRIVATE GOODS

The Product Divisibility

There are certain goods the availability of which can be decided in a discriminatory manner. A good may be priced in the market and only those may be allowed the use of it who pay its stipulated price. To put it differently, such a good may be priced and the *principle of exclusion* may be applied to its use. Those who do not agree to pay its market price, or those who *cannot* pay for it, are excluded from the use of this good. In this way, the good becomes *divisible* so far as its use is concerned. Thus, the ability to price a good, the divisibility of a good, and the exclusion principle, all go together. On the other hand, it may be that in the case of a certain good, some members of the society cannot be prevented from its consumption, provided some other members have the access to its use. A typical example would be the *defence* service. Once the country is protected against foreign aggression, every citizen is more or less equally protected and benefited. A section of the society cannot be *excluded* from enjoying the benefits of this protection. The defence service, in other words, is *indivisible*. It cannot be *priced* in the marked in order to deprive some members of the society from its use or its benefits.

People voluntarily decide to pay for the supply of a good which can be priced and to which the exclusion principle applies because those who do not pay can be excluded from its use. If, for example, an individual does not *voluntarily* agree to pay the market price for milk, the market would refuse to supply him the required quantity. But we have seen that his exclusion principle cannot be applied to the indivisible goods. And this creates a problem of raising the necessary finances in their case. For example, in the case of defence service, every individual would argue that even if *he* does not pay for it, the supply of the service will still be there. So he would rather avoid the payment and let others contribute for providing the defence service. Under the influence of this argument, very few would pay voluntarily, hoping that through the contributions and efforts of others the service will be there. This is referred to as the problem of *free riders*[2]—which means that everybody would like to have the benefit of the good without sharing the cost of its supply and so the necessary finances cannot be raised on a voluntary basis. As a result, the provision of such a good or service has to be made through

*Also called 'social goods.'

[2]James M. Buchanan, *The Public Finances*, Richard D. Irwin, 1970, p. 24.

compulsory contributions by the members of the society—such as through taxation.

In the case of a good which can be priced, the buyers would decide, through their demand preferences, whether or not it is to be supplied at all; and in case it is to be supplied, then they will also decide about the quantity of its supply. But in the case of an indivisible good, such decisions cannot be taken through market mechanism. The society has to decide the way in which these decisions will be taken and financed and these decisions need not be unanimous. As seen above, since very few individual beneficiaries will be ready to pay for it voluntarily, there is to be some form of compulsion in providing the necessary finance. The decisions regarding these goods are, therefore, left to the government agencies.

The indivisible goods, whose benefits cannot be priced, and therefore, to which the *principle of exclusion* does not apply, are called *pure public goods. Pure private goods* are completely divisible and to them the principle of exclusion applies in full measure. In the market, any one who disagrees to pay (or cannot pay) the requisite price would be excluded from their consumption.

It must be noted that the indivisibility of a good does not necessarily imply that every citizen of the society has *actually* an equal share in its benefits.[3] People living near the political boundaries of a country may, for obvious reasons, be relatively less protected. People living near public parks are actually more benefited even when the parks are equally accessible to all the members of the society. Thus, the main criterion of indivisibility is that the good in question should be equally *available* to all the members of the society (or a section thereof) irrespective of the ability or the willingness of the individual members to pay for it. The financing of the concerned activity has to be through *public expenditure* and not through market pricing.[4] This conclusion implies that the pure public goods must be in the hands of the public sector only. It, however, does not prove as to which sector (public or private) should provide the pure private goods. In order to get an answer to this question we have to consider the following additional factors:

(*i*) the level of efficiency at which the public and private sectors may be expected to operate and the productive resources at the disposal of the two sectors;

(*ii*) the political and social considerations such as the philosophy

[3]Buchanan, *op. cit.*, pp. 25-26,

[4]Exclusion here will be either impossible or ineffective and also too costly.

that the economy should not be dominated by private monopolies;
(*iii*) additional characteristics of pure public and pure private goods.

Externalities

Another important characteristic of pure public goods is the existence of externalities. The term externalities refers to the economic effects which flow from the production or use of the good to other parties or economic units. Such economic effects may also be called *spill-over effects*, *neighbourhood effects* or *third party effects*. Such an externality may be an economic gain or an economic loss to other economic units. This causes a divergence between the 'internal' (or 'private') and 'social' marginal costs (or benefits) of the good in question. Thus, for example, a power house using coal would cause a lot of ash-throwing in the neighbourhood through its chimneys. Similarly, the railways using a lot of coal in firing the steam locomotives put the residential and other areas near the railway loco-sheds to a lot of suffering on account of the smoke nuisance. This is a cost to the society but not to the individual undertakings like the power house or the railways. Similarly, plying the smoke-emitting buses and trucks in the cities adds to the social cost of these transport facilities. An example of the externalities in the form of an economic gain would be the benefits which a social overhead like a road would bring to the areas and the industries served by it.

These externalities are of two types:[5]

(*i*) market-external effects; and

(*ii*) non-market-external effects.

When the external effects cannot be priced in the market with reference to the demand and supply behaviour, they would be termed *non-market-external effects*. It means that through the market mechanism, individual economic units cannot be protected from the economic loss (or cannot be excluded from the economic gain) resulting from the public good in question. Thus, in our above example, it is highly difficult to apportion the economic gains of the new road amongst its beneficiaries. Even if it were possible to identify some of the beneficiaries such as those who actually use the road, other beneficiaries would be left out. Therefore, the pricing of the economic benefits of the road would not be strictly satisfying the role of *exclusion*.

It would follow that such public goods as have non-market external effects should be preferably in the hands of the public authorities

[5]Bernard P. Herber, *Modern Public Finance*, Richard D. Irwin, 1967, p. 27.

(provided they can run these undertakings efficiently) since they can decide about the creation and location of industries producing public goods irrespective of the commercial profitability of the same. Thus, it follows that those amongst pure public goods which have *non-market-external effects* would qualify for inclusion in the public sector. Those pure public goods which have market external effects may be left in the hands of the private sector from this point of view. (However, remember that even then the characteristic of indivisibility of pure public goods still tells us that they should be in the hands of the public sector only.)

By contrast, a pure private good is supposed *not* to have any externalities. In its case, there will be no difference between the private and social marginal costs of supply. The market pricing would, therefore, be representing the social cost of supplying the goods and so even if it is left in the hands of private sector, its supply would be at the socially optimum level. Ordinarily, therefore, the provision of pure private goods should be entrusted to the private sector. But on account of various reasons this may not be adhered to in every case. The government might decide to step in where 'merit wants' (to be discussed later in this chapter) are concerned. Other relevant considerations could be the cost conditions (discussed below), resource availability, social and political philosophy, and so on.

Marginal Cost

A likely characteristic of a pure public good is that its marginal cost would be zero or close to zero. It means that an additional member of the society can be benefited by its use without appreciably adding to its total cost. To put it differently, the use of a pure public good by one more member of the society does not reduce its availability to the others. A good example of it would be tuning in of your radio set. Still another example would be the use of a bridge, over which an additional vehicle may pass without any additional cost to the society. It must, however, be remembered that mostly this principle applies, in reality, only to a limited extent. One cannot say that we can keep on adding to the number of vehicles that may use the same bridge; we cannot even have the same defence budget if our population keeps on increasing, and so on. Also it may be added that a large number of members of the society may not be able to enjoy the benefits of the public good without adding to the cost of its supply. Similarly, the provision of the public good may be increased or decreased for budgetary reasons or due to extraneous factors. Pure public goods which possess this characteristic have a strong case for

inclusion in the public sector since public goods are indivisible also. In the case of private goods, on the other hand, the argument is basically in favour of large-scale production– for which either the society should agree to monopolistic type of private enterprise or should go in for public sector.

Decreasing Average Cost

Another likely characteristic of a pure public good is that it would be subject to the law of decreasing costs. Being lumpy, it would be subject to the economies of scale. If the public good is provided in small units, then the average cost is likely to be much more. For example, the average cost of operating a sewerage would be much less if the system serves a wide area than when it serves only a portion of the city. When it comes to the choice between public and private sectors for the provision of goods possessing this characteristic, considerations similar to the ones mentioned above in the case of 'Marginal Cost' characteristic apply.

IMPURE PUBLIC GOODS

It would be noticed that it is highly difficult to come across goods which fully satisfy all the characteristics of pure public goods. Similarly, it is highly difficult to come across pure private goods. In general, most goods would possess elements of both 'publicness' and 'privateness.' The difference between goods would be mostly of degree and not of kind. Such goods which are neither pure public goods nor pure private goods are called *impure public goods* (also called *quasi-public goods* or *quasi-private goods*). If the elements of 'publicness' are predominant in the mixture of characteristics of a good, then it may be termed a public good; and in the opposite case, a private good.

THE SCOPE OF GOVERNMENT ACTIVITY

Now the question arises as to the extent to which the State (through government and its organs) should assume the responsibility of supplying the goods to the economy. This problem may be discussed from two angles: (*i*) theoretical, and (*ii*) historical.

Theoretical Angle

Based upon the above considerations it is possible to make out a case for the co-existence between the public and private sectors. The question may be approached from the point of view of (*a*) pure public

and pure private goods; and (*b*) impure public goods.

It can be contended that so far as providing the pure public goods is concerned, we should entrust the public sector with this job. If the task is left in the hands of the private sector, then the system would suffer from inefficiency on account of the following reasons.

(1) Left to the market mechanism, even a pure public good would have to be priced. This would automatically involve the enforcement of the principle of exclusion to its use. As a result a section of the society will be deprived of the use of this good. This is highly undesirable in many cases since a number of deserving members of the society would be left out. Such an enforcing of the principle of exclusion will either be impossible or will be very costly to enforce.

(2) To the extent that some of the external effects of the public goods cannot be priced (the non-market-external effects), there will be a divergence between the private and social marginal costs of the products. The supply of goods, therefore, would not be at an optimum level. Thus, suppose that a particular public good under consideration has external economies which cannot be measured and, therefore, cannot be priced. The spill-over gains are there in the society, but the supplier of goods cannot charge for them. To him, therefore, the market price is much lower than the social marginal benefit and he determines his supply on the basis of the price which *he* gets. It means that he would produce less than what would be the optimum quantity from the society's point of view. Similarly, when a public good has external diseconomies (such as the smoke nuisance), the social marginal cost is higher than the private marginal cost. The private producer, however, would determine his supply on the basis of the marginal cost to himself and not to the society. Thus, in this case, the supply will be more than the socially optimum quantity. On the other hand, if the public goods are supplied by the State then the State can bring output to socially optimum level by either *foregoing profits* or by *suffering losses*.

As regards the quasi-public (that is, quasi-private) goods, it should appear that here the role of the State should be limited to those goods which have more of publicness in them. Those goods which are predominantly 'private' should be left to the private sector and the market mechanism. The precise field of the State activity has to be decided not only on the basis of efficiency of the public sector but also on the basis of the political and social ideology of the State.

However, though desirable, the State may not be able to provide all those goods which have predominantly 'public' elements in them for the following reasons:

(*a*) The State may not have enough of resources to undertake the supply of all the goods which, theoretically, it should be providing to the economy on grounds of 'publicness.' Such a limitation is all the more glaring in the case of the underdeveloped countries. Here the resources at the disposal of the State are much less while the market mechanism is also not so efficient. This means that there is a need to have so many goods in the public sector but the State cannot afford to undertake all these activities. In the case of our economy, for example, there is an imperative need to develop, on a large scale, roads, communications, education and health services etc.

(*b*) The administrative machinery of the State may not be efficient enough to undertake the provision of all the goods which are predominantly public in nature. This limitation is also stronger in the case of underdeveloped countries, since the administrative machinery of such countries generally lacks in skill, statistical information, and so on.

(*c*) The efficiency in public undertakings is notoriously low. There is a lack of initiative and a proper system of incentives. Also the public undertakings are expected not to follow the principle of commercial profitability in every case and the State may not be able to bear the additional losses on account of expansion of its activities.

(*d*) The extent to which a government will choose to undertake the provision of public goods also depends upon the political and social acceptability of the government policies. In some countries, the social traditions and attitudes may not allow the government to expand its activities in certain directions. In some other cases, the political atmosphere may be against certain State activities.

In the society, there are certain wants which almost all the members of the society should be able to satisfy. Examples of such wants would be educational and health needs of the society. Musgrave calls them "*merit wants*" on account of their overriding importance.[6] Provision of public goods which satisfy these merit wants helps the economy in attaining a high level of efficiency and contributes to the achieving of the basic objectives of the society. Thus if the provision of education is left to the market as such, the cost of educating the children will have to be born by their guardians. This would deprive many brilliant students of the educational opportunities. Such a state of affairs would not only be bad for those who are left out of education; it would be equally bad for the society as a whole and therefore for every one. This would cause a general lowering of the standards of

[6]Richard A. Musgrave; *The Theory of Public Finance*, p. 13.

efficiency in the economy. Similarly, the market would be providing health services to the community but again on the basis of the principle of exclusion. This would mean loss of many precious lives and the lowering of the general health standards and productive efficiency. Such a state of affairs is not a desirable one. The State should, therefore, either take up the responsibility of supplying these goods to the public or at least should supplement the market provision to the desired level. Thus, the State, through its budgetary policy, should start various government schools. It should also give aid to various private organizations which are ready to start the schools and finance a part of the activities. Similarly, the government should start hospitals in which the poorer sections of the society are able to get free medical aid. It is important to note that since such goods have both elements of publicness and privateness in them, the principle of exclusion can be applied to them in a limited way only. It means that the government can devise a price policy whereby those who can pay for these goods are made to pay or pay more than the others. The poorer sections enjoy the benefits of these goods either free or at subsidized prices.

We must note that, in the final analysis, the scope of economic activities by the state cannot be determined only with reference to the publicness of goods. It is because there is inevitably an interdependence and interaction between the State sector and the private sector of the economy. A modern welfare State has a duty to take into account this fact and thereupon determine not only the scope of its own activities but also choose the extent to which it would like to regulate the working of the private sector. In other words, the field of public finance is not limited to the *financing* of state activities only; it also covers diverse policy issues and relevant tools in the armoury of the State. Such issues, for example, would be in the categories of stabilization of income and employment levels in the economy, distributive justice and optimum allocation of productive resources. The State is expected to ensure, within its capacity, that through a proper use of the fiscal instruments at its disposal and through an appropriate use of the State sector, the productive resources of the economy are allocated efficiently, inequalities of income and wealth are reduced, the merit want of the society are satisfied and so on. It is also expected to ensure that in the formulation of public budget any inherent contradictions between chosen objectives are resolved to the extent possible.

Historical Angle

Before the advent of modern capitalism, the State used to intervene in the economic activities of the society to a substantial extent. This obviously meant interfering in the market mechanism. Such a system did not attract much criticism because the society did not have the advantages of the market mechanism with which to compare the advantages of the State intervention. But as capitalism grew, the disadvantages of controls, especially in terms of productive inefficiency, became apparent. Accordingly as a reaction to this, a thesis developed that the State should govern the least. In other words, to the extent possible, the provision of the goods should be left in the hands of the market private sector.

Adam Smith was the apostle of this thesis. He provided theoretical underpinnings for the *laissez-faire* philosophy and was a great advocate of market mechanism. Adam Smith believed that the market was capable of generating efficient signals for the economic units—there was an 'invisible hand' which guided every economic unit. However, even Adam Smith recognized that there were certain goods the provision of which could not be left to the market forces. The market would not provide them either due to the lack of commercial profitability or some other reasons. But the economy needed these goods for its own efficiency. These included social overheads, defence, and maintenance of law and order. Of course, the maintenance of the State itself was also to be there.

In due course of time, however, it was realized that more and more social wants satisfied the criteria of "merit wants" (to use Musgrave's terminology). The State, it came to be believed, was for the whole society and not for any particular section. As a result, the State was expected to work for the maximum advantage of the society. Under influence of this philosophy, the State expanded its activities in various directions. The concept of Welfare State has now gained roots and almost every State swears by it. Welfare activities form a substantial portion of what every State does these days. The States are seized of the problems of economic stability, economic growth, employment, inflation, balance of payments, regional imbalances, and so on. The precise scope of activities undertaken by any individual State, of course, depends upon the political and social ideology being followed by it, the administrative and other facilities that the State has at its command, the resources available to it, and so on.

THE CONCEPT OF A MIXED ECONOMY

In the light of the above discussion it is seen that a modern economy is a 'mixed' one in the sense that both the public and private sectors exist side by side and that the government regulates the private sector in a number of ways. The State economic activities are all-pervading in the economy. Even in the USA which is considered a representative case of a market economy, the share of the State activities is quite substantial in the total. In our country also, the relative importance of the State activities is on the increase. It is not possible to measure the exact proportion of the public sector activities in the totality of the economy but there are certain indicators on which an idea can be formed.

Take the case of India. One way in which the importance of the government activities in our own economy may be judged is by looking at the financial transactions of the government. We note that with the passage of time these transactions are becoming an ever-increasing proportion of the transactions in the economy as a whole. While the combined disbursements of our Central and State Governments were only 22% of our national income in 1960-61, they grew to the neighbourhood of 35% by 1979-80. A modern economy is to a large extent a money economy. That is to say a large proportion of its economic activities have counterparts in financial transactions involving the payments and receipts of money. With economic development the barter and self-consumption activities become increasingly smaller proportions of the total national income. Now it so happens that to support such a complicated and roundabout set of economic activities and processes like production, investment, exchange, distribution etc., credit arrangement are needed. The private sector creates a sizeable volume of private debt in the form of bank credit, mutual accommodation, bills of trade and exchange, debentures, loans, stocks and shares, and so on. But the basis of all this private credit (or claims and counter-claims of various economic units) is the currency issued by the public authorities. In India, for example, all the huge superstructure of credit is based upon the notes and coins issued by the Reserve Bank of India (In India one rupee notes and coins and other coins of smaller denominations are printed and minted by the Government of India. Currency notes of higher denominations are printed by the Reserve Bank of India. But all the currency is *issued* by the Reserve Bank of India only.) Any economic unit which enters into a payment contract with any other party, agrees to pay certain sums of money in the form of the currency issued by the

Reserve Bank of India. However, the importance of the public sector does not end here. The authorities can have a policy of varying the quantity of currency supplied to the public and this in turn will affect the creation of private credit also. Furthermore, while the financial liabilities of the private economic units are not legal tender (i.e., the creditor may refuse to accept them), the currency issued by the government or the relevant authority on its behalf is legal tender. This gives a virtual confiscatory power to the government without resorting to taxation. When the authorities issue extra currency by means of deficit financing, such extra currency competes with the existing one in the market for the purchasing of goods and services. The market is left with lesser supplies of goods and services while a part of supplies is taken away by the authorities and in the process the newly created money is left with the market.

These days, it is a usual tradition with the governments to borrow huge amounts on the market. This causes shifting of resources from the private sector to the public one. And if the borrowings happen to be from the Central bank, then the additional effect is that of adding to the total money supply also. Later on when the authorities pay the interest charges on public loans or repay the principal, shifting of resources takes place in the reverse direction. However, the government may be raising the resources for debt servicing (interest and principal repayments) by taxation or by additional borrowing. With different policies and practices, different economic effects will be experienced in the society. The authorities have a potent tool in their hands in the form of public debt and its operations. Even the central bank of the country conducts a good portion of its monetary policy through open market operations, that is, sale and purchase of governments loans. Furthermore, it can be theoretically shown that the growth of public debt is helpful, rather essential, for the growth of the financial institutions and therefore for the growth of the economy. The enormity of the public debt can be judged by looking at our own public debt figures. For example, the aggregate liabilities of the Government of India alone exceeded Rs 52,000 crores by the end of March 1980, as compared with only Rs 2565 crores at the end of March 1951. Even the treasury bills were budgeted to exceed Rs 10,000 crores as compared with only Rs 358 crores in March 1951. Similarly, employment in the public sector has been registering a rapid increase. Thus while the total employment in the public sector in March 1961, was only 70.50 lakhs, it had increased to 144 lakhs by March 1978. Since the beginning of the planning period in India, both the public and private sectors have been encouraged to grow

side by side, but in successive plans the public sector has been given a greater weightage.

Furthermore, it is not just the aggregate of revenue and expenditure which affects the working of the economy. Public revenue and public expenditure are powerful tools in the hands of the government. Through various taxation policies the government may try to mould the working of the economy in a particular manner. We shall analyse these effects in some detail at separate places in later chapters. For the time being it must, however, be realized that the field of the government activity is extending not only in terms of participation in the economy, but also in terms of regulating it.

When it comes to providing and pricing the goods, the government divides its activities into various categories. Some of the public goods like defence, law and order are not subject to the principle of exclusion. Every member of the society enjoys the benefit of the good in question in equal amount and the financing of the activity is done through budgetary provision. Some other goods, which are considered 'merit goods' are provided to the society on a subsidized basis because under free market mechanism they are generally underconsumed. Still others are subjected to the full-fledged principle of exclusion and the provision of such goods is made on the basis of commercial profitability. The basic reasons for having commercial undertakings in the public sector may be the need to have surpluses for financing other State activities and to control the commanding heights of the economy.

But the activities of the government do not stop only at having a proper and effective public sector. It also tries to regulate the working of the private sector so as to help achieve the goals of the society. For this purpose, the government adopts various budgetary measures, price controls and other direct physical measures including licensing, quotas, and so on. In India, we are quite familiar with a number of these regulatory devices.

A modern government finds that the need to intervene in the economy is constantly increasing. Even when the economy is not a centrally planned one and is depending to a large extent upon the price mechanism, there is a need to regulate the working of the economy. Left to itself, a free price mechanism is likely to generate patterns of income and wealth distribution which a society may not like from the point of view of social and economic justice. Production and trade might tend to get concentrated in the hands of a few bigger firms which may resort to various monopolistic and restrictive trade practices. A free market economy is subject to violent cyclical fluctuations from

which it should be protected and a stability of employment, production, and prices ensured. It is also contended that with the growth of industrialisation and urbanization, a lot of social security problems emerge. The problems of health, sanitation, housing, pollution and social crimes increase. A number of other similar fields for State intervention will include provision of social overheads, contribution to capital formation, labour-employer relationships, industrial security, balance of payments, and so on. In other words, there are internal economic and social problems and there are the problems arising out of the fact that the economy is subject to much stronger impacts of foreign economic and political contacts. Accordingly, the role of the State expands not only in terms of its participation in the economic activities but also in terms of protection and regulation of the economy and society in various ways. This, therefore, calls for a set of carefully planned monetary and fiscal policies and a proper coordination between them.

Thus, we see that no economy is there without a public sector. What varies is the proportion of private and public sectors in this mixture. If any society decides to completely forego the provision of public goods including the State existence itself, it would mean an anarchy. And if the activities of the State were confined only to the maintenance of the State, provision of social overheads and the protection against foreign aggression and internal disorders, then also there would be a lot of inefficiency in the provision of those goods which had more of 'publicness' in them. Therefore, the optimum level of government activity is quite a high one. The study of public finance is closely connected with this problem of the choice of the level of government activity as also the precise composition of the same.

2. MEANING AND SCOPE OF PUBLIC FINANCE

WHAT IS PUBLIC FINANCE?

The distinction between public and private goods and the concept of the public sector[1] lead us to look into the subject matter of public finance. Quite obviously, *public finance* is related to the financing of the State activities, and a narrow definition of public finance would try to say that public finance is a subject which discusses the financial operations of the *fisc* (or public treasury).[2] Earlier writers on the subject tended to define public finance in such a narrow manner, though this is not the case now.

The subject of public finance has been following the developments in State activities and the corresponding economic philosophy. Accordingly, with the passage of time, the definition of public finance has expanded to cover wider areas. Take the case of early days of capitalism when the market mechanism was establishing its superiority (especially in terms of productive efficiency) over the decadent feudal system which it was replacing. At that time it came to be widely believed that the private sector was always more efficient than the public one. Accordingly, the economic philosophy, during these days, was advocating *laissez-faire*. This meant that almost all the economic decisions were to be guided by the market forces of demand and supply which would act as an "invisible hand."[3] The role of the government was not to interfere with the working of the market forces but to limit its own activities to the barest minimum necessary.

Firstly, it was to see that the society was protected against the internal disruption, and that effective law and order situation prevailed. For this the State was to maintain itself and was to create the necessary administrative, judicial and police set-ups.

[1]*See* Chapter 1.

[2]The term *fiscal* is derived from an old Greek word which means basket and symbolizes the public purse. In the Renaissance Italian, the word *fisc* meant the treasury.

[3]*See* Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (ed. Edwin Cannan), The Modern Library, 1937, p. 423.

Secondly, the society was to be protected against any foreign aggression that might take place. The State was to maintain armed forces to meet this objective.

Thirdly, where the private sector found itself unable to create and run economic facilities which were commercially unprofitable but otherwise essential for the efficient working of the economy, the State was to step forth and assume the responsibility of creation and maintenance of such 'social overheads.' The argument for the stepping in of the State was not that the public sector was more efficient than the private sector. The basic argument was that without the public sector, the essential economic facilities (termed social overheads) would not come into existence. Social overheads, e.g., roads, bridges, and so on, contain a good portion of publicness in them. It so happens that in their case, the *social* marginal benefit usually far exceeds the *social* marginal cost. It, therefore, pays the *society* to expand social overheads. Their *private* marginal benefit, however, is much less compared with the *private* marginal cost. And as a result the *private* sector is not ready to develop them.

Therefore, under such circumstances, it is not considered desirable to leave the production of social overheads in the hands of the private sector, and thus deprive the economy of the extra benefits which it can derive from those social overheads. The State accordingly is expected to finance these social overheads out of the public funds, and run them at a commercial loss, if need be.

It must be noted that the State, according to the *laissez-faire* philosophy, was considered as something extraneous to the economy which was believed to be more or less the private sector economy only. It was, therefore, considered best that the public sector should only help and supplement the private sector and should never supplant it. It was not thought desirable or feasible to have a planned economy. The problems of capital formation and economic growth were supposed to be tackled adequately by the private sector itself. The private investors and savers would be guided by the market forces of demand and supply which basically means obeying the law of consumer's sovereignty.

Accordingly, the activities of the State were to be tolerated only as a necessary evil and were to be kept to the minimum possible scale. Thus, the real question was not to decide the basic allocation of the economic activities between the public and the private sectors and to deal with the financial and allied problems arising out of this, but rather to analyze the way the treasury should operate. With this philosophy in the background, the theory of public finance had

obviously a limited field. It was mainly considered a description of the way in which the operations of the treasury would interfere with the working of the private sector of the economy and the way in which it could keep such an interference to the minimum. Taylor, for example, says: "Public finance deals with the finances of the public as an organized group under the institution of government. It thus deals only with the finances of the *government*. The *finances* of the government include the raising and disbursement of government funds. Public finance is concerned with the operation of the *fisc*, or public treasury. Hence, to the degree that it is a science, it is the *fiscal* science; its policies are *fiscal* policies, its problems are *fiscal* problems."[4] Similarly, Carl C. Plehm says that the term public finance "has come, by accepted usage, to be confined to a study of funds raised by governments to meet the costs of government."[5]

We have already argued that a rational division of economic activities between state and private sectors may be decided with reference to the content of publicness in goods. Such approach can also be shown to satisfy the criteria of efficiency and economy. These days the interaction and interdependence between state and private sectors has come to get a due recognition and therefore, the public sector is assigned a significant role, both in theory and in practice, in a modern economy. With the passage of time, the idea of welfare state has gained currency. This has meant a corresponding widening of the scope of public finance. Thus, for example, we expect that a modern government would try to check trade cycles, reduce unemployment, bring about distributional justice, help in capital accumulation and economic growth, and remove regional disparities. Many governments resort to formal planning and an extensive use of the public sector. In line with this new approach, we, therefore, come across much wider definitions of public finance. Musgrave, for example, says: "The complex of problems that centre around the revenue-expenditure process of government is referred to traditionally as *public finance* . . .While operations of the public household involve money flows of receipt and expenditure, the basic problems are not *issues of finance* (emphasis supplied). . .we must think of our task as an investigation . . .into those aspects of economic policy that arise in the operation of the public budget."[6] Thus, the "subject matter of public finance

[4] Philip E. Taylor, *The Economic of Public Finance*, Macmillan, 1957, p. 3.
[5] Carl C. Plehm, *Introduction to Public Finance*, Macmillan, 1926, p. 1.
[6] Richard A. Musgrave, *The Theory of Public Finance—A Study in Public Economy*, McGraw-Hill Book Co., 1959, p. 3.

is logically, though not solely, concerned with the financial aspects of the business of government."[7] Similarly, Buchanan says: "The government, considered as a unit, may be defined as the subject of the study of public finance. More specifically, public finance studies the economic activity of government as a unit."[8]

The subject matter of public finance thus deals with not only the way in which the public treasury operates, it also deals with the repercussions of the different policies which the treasury might adopt and accordingly deals with the question of choice of these policies and operations. Musgrave has advocated an approach in which the state sector is viewed as a *public household*. Such a public household has certain objectives which can be grouped into the categories of: (*i*) allocation of resources; (*ii*) adjustments in the distribution of income and wealth; and (*iii*) stabilisation of prices and employment. We may add that a separate category of objectives covering capital formation and economic growth should also be there. In any case, a detailed study of public finance brings in various aspects connected with the formulation and execution of budgetary policies such as the effects of taxation. Relevant conclusions in the theory of public finance can be drawn only by bringing in the detailed discussion of not only the way in which 'public household' should itself operate (such as in the field of public sector undertakings) but also the way in which private sector would react to alternative fiscal measures. Such fiscal measures would include, for example, those of taxation, expenditure and public debt. Accordingly, it may be emphasized that Musgrave's approach, though very useful in focusing our attention upon basic objectives of the 'public household' and normative aspects of its working, cannot help us much unless we are equipped with detailed knowledge of the various components of fiscal policy and operations and unless our analysis takes into account the relevant institutional factors.

Since a modern government often operates at several levels (federal, state and local), therefore, the subject matter of public finance looks into the financial problems and policies of the government at different levels and also studies the inter-governmental financial relations.

The subject matter of public finance may be divided into the following main portions·

(1) **The Theory of Public Revenue**. This portion deals with the several sources from which the State might derive its income. It dis-

[7]Musgrave, *op. cit.*, p. 3.

[8]James M. Buchanan, *The Public Finance*, Richard D. Irwin, 1970, p. 16.

cusses and analyzes the comparative advantages and disadvantages of various forms of revenue and the principles which should govern the choice between them. Of the various sources of public revenue, taxation, public debt and creation of additional currency claim our special attention.

(*a*) In the study of taxation, we cover various principles governing the choice of tax measures, the problems of incidence of taxation, and the effects of taxation on the working of the economy.

(*b*) Resorting to the printing press by the authorities has its own advantages, dangers and limitations and deserve a special attention.

(*c*) Similarly, it is convenient to study the public debt problems separately.

With modern governments, public debt has become an important source of revenue, but that is not all. Servicing of the public debt causes disbursement of public funds and belongs to the public expenditure side. Moreover, public debt has assumed the role of an important instrument for regulating the working of the economy.

(2) **Theory of Public Expenditure.** Through public expenditure the government contributes to the financial flows of the economy and conditions the demand and supply patterns. Public expenditure is also a major tool in the hands of the authorities for implementing their welfare, growth, stabilization and other policies.

(3) **Financial Administration.** All financial activities involve the question of financial administration. Financial administration relates to the public budget, its passing, implementation, auditing and similar other matters.

(4) **Stabilization and Growth.** These aspects of the economic policy of the government have assumed such a great significance that they are often given a separate treatment in the discussions of public finance theory.

DISTINCTION BETWEEN PRIVATE AND PUBLIC FINANCES

It is usual to discuss both the similarities and dissimilarities between the public and private finances. By private finance is meant the financial problems and policies of an individual economic unit (which does not form a part of State organs) as compared with those of the public authorities.

Similarities

Modern economies are monetized. That is to say, most of the economic processes have financial counterparts in which financial assets

are used (or even created). Some of the activities may be non-financial in nature, but a major portion of the activities would involve the creation and use of financial claims. *Both the private and public sectors are engaged in activities that involve lots of purchases, sales and other transactions. Similarly, they are engaged in production, exchange, saving, capital accumulation, investment. and so on.* In order to finance these operations, the government, amongst other things, would be creating money (which is also a financial asset), raising loans, making payments, etc. Similarly, a private economic unit would also be lending, borrowing, receiving payments, making payments, and so on. In these respects, therefore, both the public and private finances are quite similar to each other.

One may also point out that both the private and public sectors are engaged in satisfying the wants of the society. The overall economic activities are being shared by the two sectors and in that sense their problems and decisions are similar. *Both have limited resources at their disposal. and are trying to make the best use of them by taking decisions such that the "most important" wants are satisfied first.*

But the similarities between the two types of finances almost end here. The differences are quite sharp between the two.

Dissimilarities

To begin with, it may be stated that *private economic unit has to live within its means.* If need be, it may resort to deficit budgeting (that is having an expenditure more than the income), but it can do so only for a short period and upto a limit. *The State, on the other hand, can resort to a policy of permanent deficit budgeting.* The difference emanates from the fact that without repaying its earlier loans, a private economic unit loses its credit standing in the market, but this need not happen to the State. The State can plan to add to its debt with every budget, and may succeed also. A number of governments are doing this virtually. The result is that the public debt in many countries is a high proportion of national income.

It is, however, not only a question of the amount of possible borrowing that distinguishes between the private and public finances, *it is equally a question of the form of borrowing and the rate of interest that the borrower has to pay. A private economic unit cannot raise non-repayable loans*, but the State may and sometimes does.[9] *The State*

[9]For example, the Government of India has two non-terminable loans: (*a*) The first loan was raised in 1896-97 and is of the face value of about Rs. 8 crores; (*b*) the second loan was raised in 1946 and has a face value of about Rs 248 crores.

can borrow both internally and externally, that is, it can borrow from those who are subject to its authority and from those who are not. But a private economic unit (such as a firm) cannot raise an internal loan; all its loans have to be 'external.' Furthermore, on account of high creditworthiness the State can borrow at a rate much lower than the private economic units will be able to. It has generally the help of the central bank of the country as an agent and as an underwriter when the loans are floated in the market. It draws upon the facilities of the banking and other financial institutions more liberally. In some cases, the State may even adopt indirect coercive methods to borrow at lower rates, as is done in India.[10]

Another important difference between the public and private finances is *the power of the government to create currency*, that is, money which the creditors cannot refuse to accept in discharge of the debt obligations of their debtors. The currency created by the government or a competent authority on its behalf is legal tender. In olden days, when currency used to consist of the metallic coins, the power of the government to augment its resources via the use of currency was limited. It could resort to the debasement (depreciation) of the metallic content of the coins but to a certain extent only. But with the introduction of paper currency, the authorities have gradually added to their power to increase currency supply; and in a number of cases, they have now an unbriddled discretionary power to do so. The formal technical restrictions often can be waived if the government so wants. Such types of restrictions only indicate procedural handicaps but not essential checks.

The upshot of the argument is that the government can just *create* purchasing power and join the demand side of the market and take away a share of the produce. The rest of the economy will be left with much less supply of goods and more money than before. A private economic unit cannot do so. Its obligations can never become legal tender. A private economic unit is always expected to pay back its obligations. The issue of paper currency does not impose any such obligations on the government.

There is a basic difference between the approaches adopted in public and private finances. *Private finance follows 'the market principle', or the principle of economic rationality; but the public finance follows the budget principle.* "The essence of the budget principle is that the services in this sphere are determined not by profit expectations and

[10]We have what is called a 'captive market' for public debt whereby the banking and other institutions are forced indirectly to subscribe to government loans.

the willingness of the individuals to spend their money for the purchase of such services, but by decisions reached through political and administrative procedures and based on common social objectives."[11] The State does not go by the principle of *quid pro quo*.

Quite often, in private finance, the view taken would be a short-term one. It is not so with the State. The State would be considering the interests of the economy as a whole and for that purpose, would be ready to suffer commercial losses, both in the short run and in the long run. Also the State would keep in mind the fact that the society is a perpetual entity and for its welfare many activities are needed which have no immediate economic return, even to the society. An example in case is the investment of the State in removing untouchability.

It is generally pointed out that *while a private economic unit would be proceeding by first ascertaining its income and then determining its expenditure, the government first decides about its expenditure and then goes round to seek revenue for it. It is an erroneous idea based upon the outmoded thinking* that the activities of the State would be confined to the minimum possible and that the State would then find out the best ways of financing them. These days, however, it is not so. It is realized that the activities of the State are not fixed ones. They are ever widening and with the increasing complexity and growth of the society, it is found that the *need* to increase State activities is going up. The government, therefore, has to expand its activities and such expansion is restricted, amongst other things, by financial considerations also. Though the State, theoretically speaking, has complete powers of raising more revenue through taxation, confiscation, borrowing, and printing notes, it would use these powers only within limits so that the fabric of the economy is not out-stretched. For example, over-borrowing by the State could starve the capital market and private investment. Too much of note printing would lead to inflationary pressures and other problems in the economy. Excessive taxation may discourage saving and investment and productive activities in the economy, and so on. Therefore, *in practice, the government does not use these powers indiscriminately*. It realizes that in the ultimate sense it can use more resources either by transferring them from the private sector or by producing them. Taxation, borrowing, and printing notes by themselves *do not add* to the productive resources of the society. They only lead to the transferring of resources to the

[11]Gerhard Colm, *Essays in Public Finance and Fiscal Policy*, Oxford University Press, 1955, p. 9.

State. For various reasons, the government may not and would not want to transfer these resources at a rate faster than the existing one.

Therefore, *the expenditure programme of the government is, to a great extent, conditioned by the revenue considerations.* Moreover, in terms of its philosophy, the State may find itself unable to extend the sphere of taxation. Thus, these days, most governments have a system of progressive taxation whereby the richer sections are taxed more heavily. If they are already taxed as much as could be acceptable, the government may not want to extend its tax net which will then catch the poorer sections.

In the same manner, a private economic unit does not mechanically go about deciding how much to spend. The wants of a private economic unit would also be generally too many and within limits it has to work out the possible ways of increasing its income.

Thus, we note that in spite of some similarities between the public and private finance, there are some very important fundamental differences between them. In order to study public finance, we have to keep these basic differences in mind, since it is obvious that on their account a number of private financial principles will not apply to public finance. Differences like the very objectives of private finance and public finance, or the ability of the authorities to create money, to borrow, to tax, and so on cannot be ignored. But in order to appreciate the basic nature of public finance, it is equally essential to remember that the public sector is a part and parcel of the economic totality of the economy. The activities of the public and private sectors are interrelated and interdependent and involve a good amount of mutual transferring of resources. The policies adopted by the authorities have to be analyzed in the light of these observations. Public sector is, as we have seen earlier, not something superimposed upon the private sector. It is to be viewed as a part of the total economic system and not something to exploit the private sector.

In order to understand the nature of public finance and its principles, one has to be equipped with the knowledge of the way the economy as a whole works, the way various financial flows take place in the economy and the corresponding economic activities that are there. The activities of the State bring about changes in these financial flows in their own ways and the subject matter of public finance has to be discussed in the light of all these implications.

PUBLIC FINANCE AND THE ECONOMIC SYSTEM

As seen above, the classical approach to the study of public finance

was in terms of minimum of governmental activities. It was based upon the assumption that the private sector was always more efficient than the public sector from which it followed that to the extent possible, the economic activities should be entrusted to the private sector only. It was argued, accordingly, that the 'sound budgetary policy' of the government was to balance the budget. Running into deficits would make it indebted to the market. The very existence of the public debt causes a financial burden upon the future public budgets and an 'undue' interference with the working of the economy.[12] If at all the government runs into a deficit, say during a war, it should try to redeem the consequent debt as quickly as possible. There is another danger in the practice of budgetary deficits. Since it is easier to transfer resources from the private to the public sector through deficit financing (especially through printing of additional currency) than through additional taxation, the government tends to indulge in irresponsible spending and creates inflationary pressures. Similarly, one can argue against surplus budgets. A surplus budget would imply a heavier than needed taxation and would tend to reduce the demand in the market with possible unemployment and depression.

It was realized, in due course, that the market mechanism, which guides the working of the private sector is not an unmixed blessing. It leads to certain undesirable results such as discussed below.

A market economy is subject to trade cycles which, with the passage of time, tend to increase in amplitude and severity. This indicates a need for stabilizing the income and employment in the economy. These days, the discussion of stabilization policy forms an integral part of the theory of public finance. Further, market mechanism not only generates income and wealth inequalities, it also perpetuates them and enhances them. Amongst other causes, one reason for this phenomenon is the fact that in market mechanism income distribution takes place neither on the basis of the relative needs of the members of the society, nor in terms of their relative contributions to the national income. Instead, income distribution takes place in terms of the ownership of the factors of production and their pricing in the market.[13] In addition to large-scale inequalities and recurring un-

[12]Ricardo, for example, called the public debt a 'terrible scourge.' *See* David Ricardo, "Principles of Political Economy and Taxation," *The Works and Correspondence of David Ricardo*, Vol. I, p. 197.

[13]An individual member of the society may supply various factors of production to the economy, such as his labour, capital, land etc. His income from any one factor will depend upon the amount of the factor he supplies and the rate at which the said factor is paid for in the market. By adding his earnings from all the factors supplied by him, we get his total income.

employment, there is no social security. Members of the society are not entitled to any help in the event of unemployment, sickness, and so on. Furthermore, market mechanism is not particularly suitable for the supply of either public goods or merit goods.

All these considerations strengthen the case for the public sector as an effective alternative to the private sector in many ways. Some specific arguments have also been extended in favour of the public sector. We have seen some of these arguments, such as the need to have the public sector for the provision of public goods and the merit goods. Protection of the labouring classes against unemployment, sickness, old age, etc. is an important consideration with the authorities. These days they are equally concerned about the need to stabilize the economy. Such a stabilization requires regulation of the effective demand in the country. Accordingly, the old dictum that the government must try to balance its budget as a 'sound budgetary policy' stands discredited. It has given place to what is called the "functional finance."[14] According to it, what is needed is not a balanced or unbalanced budget as such, but stability and growth of income and employment in the economy. For this purpose, it may be necessary to add to or subtract from the effective demand created by the private sector. If a particular tendency, such as a deficiency of effective demand, persists in the private sector, there would be no harm if the State sector repeatedly incurs a deficit. The emphasis here is on the relevance of the total effective demand which both the private and the public sectors have to create rather than worrying about the recurrence of a deficit or a surplus budget as such. "If one adopts wholeheartedly the principle that governmental financial operations should be regarded exclusively as instruments of economic and public policy, the concept of a balanced budget, however defined, can play no role in the determination of that policy."[15]

This view is further strengthened by the recognition that public debt can be an important and effective instrument of economic policy, especially in stabilization. This view was emphasised by the Radcliffe Committee[16] in England. The precise way in which public debt may be used as a stabilizing instrument is debatable, but its importance is beyond doubt.

[14]A. P. Lerner, "Functional Finance and the Federal Debt," *Soc. Research*, February 1943.

[15]A.H. Hansen, *Fiscal Policy and Business Cycles*, p. 188.

[16]Committee on the Working of the Monetary System (Radcliffe Committee), *Report*, Cmnd. 827, Her Majesty's Stationery Office, Great Britain, August 1959.

Gurley and Shaw, in their famous book *Money in a Theory of Finance*[1],[17] have provided a theoretical basis for creating public debt. According to this view, an economy can have a healthy growth only if it has a sound financial structure. In such a financial structure, the public debt has an important and indispensable role to play, since the financial structure is dependent upon the provision and soundness of public debt (including the currency supply).

[17]John G. Gurley and Edward S. Shaw. *Money in a Theory of Finance*, The Brookings Institution, 1960. (Reprinted by Motilal Banarsidas, Delhi).

3 PRINCIPLE OF MAXIMUM ADVANTAGE

The Principle

Financial operations and policies of the State have assumed significant proportions in the financial flows of most modern economies. Budgetary and debt policies have now become important tools in the hands of the authorities for regulating the economy. The authorities are constantly adding to, subtracting from and bringing about other changes in the economy's financial flows through public expenditure, taxation, and so on. This way, a constant reconditioning of the demand and supply forces is taking place and thus public finance has become an important variable in the determination of national income, employment, output, prices and other parameters in the economy. It is, therefore, imperative that such an important and potent tool like the public finance be used with judicious and thoughtful planning. The purpose should be to design the policy and operations of public finance so as to achieve the maximum possible welfare or advantage for the society as a whole. The criteria adopted in this connection may collectively be called the 'Principle of Maximum Social Advantage.'

The principle of maximum social advantage was not approached in a proper way by the older writers on public finance. They made unrealistic assumptions and reached faulty conclusions regarding the best possible public finance policy or the optimum level of budgetary activities of the State. Their main fault was that they assumed that the State was an entirely extraneous body to the main economy (which was considered to be a market economy). The State, according to them, was a necessary evil which could not be done away with. But it was an economic burden upon the economy and, therefore, the best possible position was the one where the State activities were kept to the minimum. In order to maintain itself and its necessary operations, the State had to raise revenue through taxation. This made the society poorer than it was because taxes are compulsory levies upon the resources of the society. In other words, it was believed that every tax caused a disutility to the society on account of the fact that some resources were transferred from the society to the State. The welfare of the society suffered accordingly. The

general conclusion, therefore, was that the society must be taxed as little as possible. It was on this basis that J.B. Say pointed out in the nineteenth century that "the very best of all plans to finance is to spend little and the best of all taxes is that which is least in amount." It amounted to saying that the State activities must be kept to the minimum. This was another way of saying that the best the State can do for the economy is to keep the harm (that it inflicts upon the economy through taxation) to the minimum.

By agreeing with the unrealistic assumptions that all taxes drain away the economy's resources and that all public expenses restore these resources to the economy, we can lay down prescriptions regarding government's budgetary policy aimed at achieving maximum social advantage. With this end in view, we make the following additional simplifying assumptions.

(*i*) The public revenue consists of only taxes (and not of gifts, loans, fees, etc.), and the State has no surplus or deficit budgets;

(*ii*) Public expenditure is subject to diminishing marginal social benefit and the taxes are subject to increasing marginal social disutility or cost. It implies that the State expenditure will be first directed towards those lines which are most beneficial to the society and the State taxes will drain away resources from those lines where they are least useful.

On this basis, as the State increases its taxation and expenditure activities, the social benefit from each additional rupee spent falls while the dissatisfaction from each additional rupee taxed increases. This way, a stage is arrived at when the rising marginal dissatisfaction of taxation becomes equal to the falling additional social benefit of expenditure. At this stage, the State should stop expanding its public finance operations. It is no longer beneficial to further expand the State activities because the social benefit of the marginal unit of public finance operation is no longer larger than the corresponding social dissatisfaction. However, on all the intra-marginal units of taxation and corresponding State expenditure, there would be a net gain and the sum total of this gain would be the maximum possible when the marginal social benefit and marginal social cost are equated. Thus, at this stage the public finance operations would be yielding the maximum possible advantage.

The above proposition of maximum social advantage can be depicted graphically also (Fig. 3.1). Through this graph the optimum tax and expenditure activity of the State can be determined. In the accompanying diagram, let public expenditure and taxation be measured along the *X*-axis and let the social benefit and cost be mea-

sured along Y-axis. The quantities measured along Y-axis will be positive if measured above X-axis and negative if measured below X-axis. As a result, the curve showing the marginal social benefit from public expenditure will lie above the X-axis and the curve showing marginal disutility from taxation will lie below X-axis. In the diagram, the curve BB' shows the marginal social benefit accruing to the society from different amounts of the public expenditure. The curve DD' shows the marginal social cost to the society from the taxation levied by the State. The difference between BB' and DD' indicates the

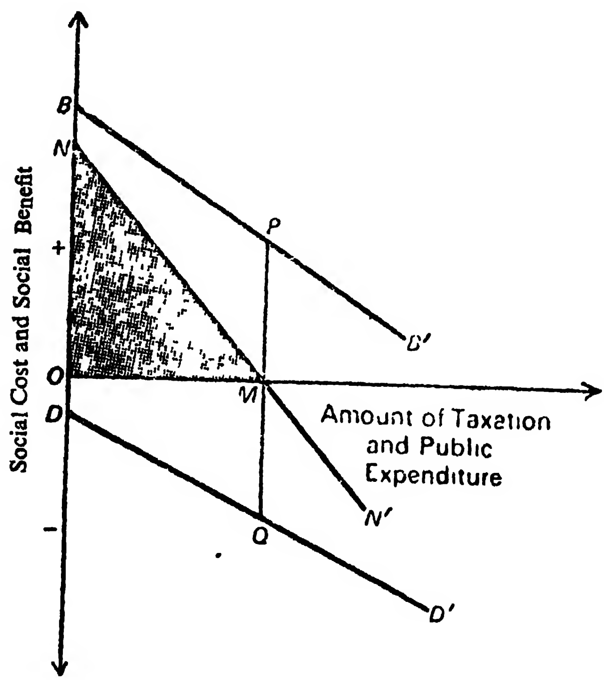

FIG. 3.1

net social benefit or advantage (that is the excess of the benefit over the cost to the society), and is depicted by the curve NN'. We find that when an amount OM is taxed and spent by the State, then the marginal social benefit and marginal social disutility are equated (MP being equal to MQ). Till then, the gain to the society is more than the loss. It is here that the State should stop expanding its activities. The net gain to the society (or the maximum possible social advantage) is equal to the shaded area ONM. If the State stops its public finance operations at a figure less than OM, the society will be foregoing a possible gain. If the operations are expanded beyond OM, the total net benefit will again start falling.

Limitations

The simple exposition of the principle of maximum social advantage as described above suffers from some obvious limitations.

(1) The principle of maximum social advantage can be refuted even if we agree with the proposition that the State is a superimposed entity upon the economy. So long as we agree that it is essential to have the State and that it is necessary for the State to perform certain basic functions like the protection of the society from both internal disaster and external aggression, it follows that the benefits from the existence of the State are more than the cost of maintaining the State. Actually, without these basic functions of the State the very existence of the society cannot be guaranteed. And also, the protection available to the society invisibly adds to its productive efficiency.

(2) As Dalton points out, there is no basis for a generalization that every tax is a burden upon the society and that every State expenditure is a benefit for it. We can explain this point with many a real life example. A tax on the consumption of narcotics and other harmful drugs cannot be called a burden upon the society, though a similar tax on education or sanitation will be. Similarly, if the State undertakes the provision of social overheads and other public utilities, it leads to the emergence of external economies. Through them the cost of production falls, efficiency in production goes up and the economy benefits. The State through its activities may succeed in breaking the vicious circle of poverty of an underdeveloped country and in this way it may return to the economy (in the form of economic growth) more than it gets from it.

(3) Moreover, budgetary benefits and ill-effects to the economy are not generally limited to the period covered by that budget only. Effects of one budget would mostly spill over to the following periods. Accordingly, appropriate time lags and effect-spreads should be worked out, and it would be a deficient logic to argue in terms of any single budget.

(4) If we assume that all taxes are harmful and all public expenditure is beneficial, we arrive at some absurd results. For example, it will follow that the best course for the State would be not to levy any tax at all and finance all its activities through deficit financing only. It is very easy to demonstrate the absurdity of this conclusion. We must remember that taxes by themselves, or public expenditure by itself would not destroy or create any resources; through them only a transfer between the private sector and the public sector of the economy will take place. Any variation in the overall resource availability that may come about would be only an indirect result of the public

finance operations.

(5) Non-tax revenue includes fines, fees, profits from public undertakings, use of the printing press, market borrowings, and so on. These sources of revenue cannot be dismissed as unimportant either quantitatively or in terms of their effects on the welfare and working of the economy.

(6) Every State is committed to certain expenses—a liability it cannot free itself from easily. These expenses include the maintenance of the State itself, defence of the country, maintenance of law and order in the society, imparting justice to the people, certain welfare measures (such as old age pensions), servicing of the existing debts, and so on. Even if the authorities believe that some of these expenses should be reduced, it is not easy to do so.

(7) The effects of public finance operations are complex and widespread. It is not easy to identify and quantify these repercussions. Thus, indirect taxes often change the relative prices of the commodities being taxed. This changes the demand, consumption, production and investment patterns of the society. The welfare and growth effects of public finance operations cannot be linked with the *amounts* of taxation and public expenditure.

(8) To assume that the government budgeting should not involve a surplus or a deficit is a highly unrealistic restriction. If the objective of the budgetary policy is to be of maximum advantage to the economy, such a restriction is most likely to hinder the attainment of this objective. Contra-cyclical budgetary measures to offset the fluctuations in the demand generated by the private sector are often suggested. In an underdeveloped country, a deliberate deficit budgeting may be needed to stimulate savings and capital accumulation.

(9) To argue the determination of an optimum level of State activities in terms of *aggregates* is highly objectionable. The actual composition of the revenue and expenditure aggregates would be equally relevant to the discussion of what benefits or harms the budgetary operations might bring to the economy. This, therefore, brings in a host of relevant questions regarding institutional and economic framework of the country such as income and wealth inequalities, the regional imbalances and the like. To put it differently, the question of determining the optimum level of State activities leads us to consider in detail the *effects* of alternative budgetary policies at different levels and in all their details; and without such an analysis no meaningful answer is possible.

The Principle in Practice

If the principle of maximum social advantage as explained above is unrealistic and suffers from so many limitations, should we give it up totally? The answer is, no. Instead, we should try to make it more realistic and capable of yielding policy conclusions. For this purpose, we first show that it is highly undesirable to limit the State's budgetary activities to the minimum possible. And then we try to find out the tests which could tell us as to when the budgetary activities of the State were adding to the social advantage.

The case for the limiting of the State activities rests on the assumption that the private (market) sector of the economy is capable of generating full employment and that it is always more efficient than the public sector. Given these assumptions, it follows that the State should try to limit itself to the minimum possible role, though within this role, it could choose between different taxes and expenditures in a judicious manner. But we note that if one of the above mentioned two implicit assumptions is discarded, the question assumes an entirely different complexion. If the market economy is not that efficient, then? If it cannot guarantee full employment, a case for State intervention arises. Even after granting that private sector is productively more efficient than the public one, a number of situations arise which spell out sub-optimal results—that is to say the results in terms of employment, capital accumulation, rate of growth and so on are not the best possible. Similarly, left to itself the market economy would generate fluctuations in income, employment, and prices. There would be inequalities of income and wealth. The State must come forth to bring about optimal results in the economy by removing these defects.

Furthermore, we must remember that though competition is supposed to guide the economy according to the consumer's sovereignty, there are really two defects here.

Firstly, on account of inequalities of income and wealth, the demand pattern generated in the market does not really display the true needs of the society. Quite a number of luxuries are demanded at the cost of necessities which the poor people cannot afford to buy for want of purchasing power. There is also a shortage of public goods due to non-profitability of these products.

Secondly, the market competition, in practice, tends to degenerate into a monopolistic competition in which there is a lot of wastage on account of selling expenses, unutilized excess productive capacity, hoarding, speculation, and so on.

Having shown that the State cannot remain indifferent to the

working of the economy, we proceed to look for the tests of maximum social advantage. To make these tests realistic we treat the State as a part and parcel of the economy. In such a case, it is obvious that the sweeping statements like the ones asserting that all taxes are leakages from the economy's resources and that all public expenditures are additions to them, lose their meaning. What is relevant is, then, the net effect of the activities of the State both in taxing the economy and in increasing the public expenditure. Furthermore, it would not be proper to compare the total of taxes with the total of public expenditure. We shall have to look into the composition and magnitudes of these taxes and their rates etc. Similarly, the composition and magnitude of public expenditure will have to be analyzed before any final judgment can be delivered. For example, for curbing inequalities of income and wealth, and for curbing monopolies or inflation the State may be imposing taxes. Such taxes are likely to have beneficial effects. It must also be remembered that not all public revenue comes from taxes alone and not all public expenditure need be in money terms. For a proper and fuller analysis we have to look into the incidence and effects of taxation and effects of public expenditure, and so on.

Thus, till now, we come to the conclusion that it is not possible to generalize either about the benefits or about the disutility of public expenditure and taxes. A proper study of the tax and expenditure structure is needed to arrive at the relevant and useful conclusions as to whether some existing taxes should be replaced, added to, abolished or changed. Similarly, a fully detailed analysis of the public expenditure is needed. But this is not an easy task. In the economy, the results of many State activities cannot be put in quantity terms. As examples, we can mention the removal of untouchability, spreading of education, improvements in health and sanitation, and so on. Almost every State activity has widespread effects and it is nearly impossible to estimate all these effects In other words, it is very difficult to devise objective tests of benefits and losses to the society and thereby get the maximum social advantage arising out of State activities.

However, even under these difficult (but realistic) conditions, Professor Dalton gives us certain *objective* tests according to which it can be ascertained whether the public finance operations are adding to the social advantage or not. These tests are formulated by assuming that there are certain desirable objectives which the society should try to achieve. It is thought that there would be no difference of opinion about the desirability of these objectives.

The first such test is that of preserving the society. If it is agreed that the society, as it exists, is worth preserving, then the public finance system which ensures adequate protection to the society against both foreign aggressions and internal disruptions is worth pursuing. In other words, if the public finance operations are directed towards protecting and preserving the society, then such operations are certainly adding to the social advantage.

The second test which Professor Dalton mentions is that of increasing the economic welfare of the community. This welfare involves two aspects: (*a*) an improvement in production; and (*b*) an improvement in the distribution of national income.

An improvement in production should not be taken to mean an increase in current output as such, but basically an increase in the productive capacity of the economy. It would not be desirable to increase current output through capital consumption. Improved productive capacity implies capital accumulation, reduction in unemployment, better utilization of resources, and an increase in the productive efficiency of the workers. Therefore, the public finance operations which help the economy in achieving an improvement in production add to the social advantage.

The second aspect of the welfare, namely, an improvement in the distribution of national income, is a complicated thing. It covers both "efficiency" and "equity" sides of distribution. Efficiency in distribution relates to aggregate of satisfaction only, while equity relates to the redistribution of satisfaction such that one party gains at the cost of the other. Normally, the two aspects are so intermixed and interdependent that a decision involving efficiency affects equity also and vice versa. The welfare aspect of distribution of national income, therefore, does not lend itself to an easy treatment. Quite often, we are not even able to find out whether certain decisions are adding to the efficiency of distribution or not. In other cases, the efficiency and equity sides might clash, so that improvement in one would imply a deterioration in the other. It is not, therefore, possible to lay down full-fledged scientific criteria of social advantage. But we can recommend some commonsense steps about which, on general grounds, there is not much chance of a difference of opinion. We can, for example, advocate reduction in inequalities of income and wealth, reduction in unemployment, uplifting the standard of living of the people, bringing about a higher rate of economic growth, bringing about economic stability in the economy, and so on.

Mrs Hicks has also suggested two sets of criteria for judging whether a particular public finance operation or policy would add to

the net social benefit or not. The first is called the *production optimum* and the second is the *utility optimum.*

By reallocating the productive resources of the community, it is generally possible to vary the output. According to Mrs Hicks, an optimum in production is achieved if we cannot increase the production of any commodity through reallocation of productive resources without reducing the output of another commodity. It is very clear that by itself, this criterion is quite ambiguous and may be even misleading. Increasing production of one commodity may necessitate reducing that of the other, but the total output may increase. Mrs Hicks's production optimum is satisfied if full employment is achieved and there is no wastage of existing productive capacity. However, it must be noted that budgetary operations and policies are not always successful in achieving even these conditions. If they could, many of the economic ills of the world of today would not have been there. Again, this criterion of production optimum has been in terms of short-run only. In the long-run, it is possible to think in terms of various alternative ways of augmenting the productive capabilities of the economy. These would include decisions about the creation and expansion of social overheads, capital goods sector and investment in *human capital.*

Utility optimum of Mrs Hicks is related to the composition of the national output and the relative importance of its component elements. By varying the composition of national income, its total utility to the society may be increased or reduced. When a situation is reached whereby such a variation cannot possibly add to the total satisfaction, the utility optimum is said to have been achieved. The difficulty with this criterion arises out of the fact that utility cannot be measured and therefore definite measures of relative importance of different goods and services cannot be laid down. Furthermore, such measures of relative utility are subject to a variation over time, over place and between individuals.

All said and done we find that the idea contained in this principle is useful, though the principle itself cannot be applied in strict quantitative terms. Instead, we should proceed with the aim of making overall budgetary policy of the government as useful to the society as we can. To this end, we should first equip ourselves with adequate theoretical knowledge and empirical evidence regarding the immediate and long-term repercussions of various budgetary measures. We have then to choose between various alternatives which budgetary policy offers including the level of State activities, the composition of tax and non-tax revenues, the rates of such taxes,

and similar considerations regarding the expenditure side of the budget. All these decisions, therefore, have to be taken in the light of our objectives and the extent to which they can be achieved in practice. It may also be emphasised that the effectiveness of budgetary measures can be tremendously enhanced by improving the official accounting system and by introducing programme and performance budgeting. The optimum level of State activities is not a fixed quantum. It would depend upon all the relevant considerations enumerated above, viz., the objectives, their practicability, their relative costs and benefits, the administrative capability of the government including the accounting system and the programme and performance budgeting, the institutional and economic framework of the society and the like. Therefore, in overall terms, we can only proceed to think of the particular projects, their social costs and benefits and whether or not they should be in the public sector.

4 PUBLIC REVENUE—GENERAL CONSIDERATIONS

Like any other economic unit, a government also needs funds to finance its activities. Such funds are raised from various sources. It is difficult to give a complete list of all the sources of public revenue, but the important and common sources of public revenue would include taxes, income from currency, market borrowings, sale of public assets, income from public undertakings, fees, fines, gifts and donations, etc. Professor Dalton[1] points out that in some cases it may be useful to make a distinction between public receipts and public revenue. While public receipts would include income from all sources, public revenue is a narrower concept and does not include public borrowings, income from the sale of public assets, or income from the use of the "printing press."[2]

Before we take up a theoretical distinction between various forms of public receipts, it would be helpful to illustrate different kinds of public receipts by looking at the receipts of the Government of India. Central Government receipts are divided between two main categories—revenue receipts and capital receipts. Our Constitution under Article 112 makes it obligatory to divide our budget into revenue and capital portions. But this distinction also rests upon an economic reasoning. Capital budget covers the creation and disposal of assets and liabilities, particularly connected with variouspr ojects. Revenue budget covers the current receipts and running expenses. It is for this reason that interest, dividends and profits are included in revenue portion of the budget.

Revenue Receipts

Let us first take up the receipts under revenue account. These

[1]H. Dalton, *Principles of Public Finance*, London, Routledge & Kegan Paul Ltd., p. 26.

[2]This term is used to denote the additional money supply created by the authorities by printing and issuing paper notes. By this act, the authorities add to the purchasing power available to themselves.

receipts are divided into tax-revenue and non-tax revenue. Tax-revenue itself is divided into three sections:

(*a*) Taxes on income and expenditure: This section covers corporation tax, income tax and similar other taxes, if any, in force.

(*b*) Taxes on property and capital transactions: This section includes estate duty, wealth tax, gift tax and 'others,' such as land revenue and stamps and registration fees with respect to Union Territories without legislature.

(*c*) Taxes on commodities and services: This section includes customs (namely import duties, export duties, cesses on export and other receipts), union excise duties (namely basic excise duties, auxiliary duties, earmarked cesses, and additional excise duties in lieu of sales tax) and other miscellaneous receipts like the following: certain taxes which the Central Government levies and collects in Union Territories and tax on foreign travel etc.

The non-tax revenue is similarly divided into three sections:

(*a*) Currency, coinage and mint: This category covers the receipts of Currency Note Press at Nasik, Security Paper Mill at Hoshangabad, Bank Note Press at Dewas and of the Mints. Profits from circulation of small coins are also included here.

(*b*) Interest receipts, dividends and profits: This section comprises, apart from interest receipts on loans by the Central Government, dividends and profits from public sector undertakings and contribution from railways and posts and telegraphs and also includes surplus profits of the Reserve Bank of India transferred to the Government.

(*c*) Other non-tax revenue: This section covers revenue from various government activities and services such as from administrative services, public service commission, police, jails, agriculture and allied services, industry and minerals, water and power development services, transport and communications, supplies and disposal, public works, education, housing, information and publicity, broadcasting, grants-in-aid and contributions etc.

Capital Receipts

Here the first category is that of market borrowings—loans which have a maturity of 12 months or longer at the time of issue. Receipts on this account would be considered as market borrowings even when some of these loans are taken up by the Reserve Bank of India. Part of these long-term loans may consist of *funding* of *ad hoc* treasury bills (that is, the conversion of these treasury bills, which have a maturity of 13 weeks at the time of issue into *long-dated* loans). Borrowing will also include special bonds, if any. For exam-

ple, in 1975-76, the Central Government borrowed through special bonds under Voluntary Disclosure Scheme.

The second category of capital receipts is that of external loans. It may be noted here that only the Central Government is authorized to raise loans from abroad. The next category of capital receipts consists of recoveries of loans and advances made by the Central Government to State Government, Union Territories and non-Government parties. There are also receipts in terms of small savings which comprise of Post Office Savings Bank Deposits, Post Office Time Deposits, Cumulative Time Deposits, Recurring Deposits and National Savings Certificates. Two-thirds of the net Small Savings collections in each State are paid to that State as loans. Besides, for every 5 per cent excess over the national average of the ratio in a State of net to gross collections, that State is paid additional loans to the extent of $2\frac{1}{2}$ per cent of net collections.

We have also the category of provident funds. State Provident Funds relate to various provident funds of the Government employees, while Public Provident Fund represents collections under the Public Provident Fund Scheme framed under the Public Provident Fund Act, 1968. There are also collections under Special Deposit Scheme introduced by the Government of India with effect from 1 July 1975 which enables the non-Government Provident, Superannuation and Gratuity Funds to invest 20 per cent of their monthly accretions.

Other capital receipts represent the net effect of transactions occurring under other funds and accounts, deposits, suspense, remittance etc. These receipts, for example, include special borrowings from the Reserve Bank of India, deposits under the Scheme of Compulsory Deposit of Additional Wages, half of Dearness Allowance increases and percentages of income of income-tax payers. There are also deposits of US Rupee Balances, Railway Reserve Fund, Railway Pension Fund, Railway Depreciation Reserve Fund, Railway Revenue Reserve Fund, Railway Development Fund, Railway Accident Compensation, Safety and Passenger Amenities Fund, P & T Revenue Reserve Fund, etc.

In this and some of the following chapters we shall discuss taxation. This will be followed by an analysis of public debt and public undertakings.

TAX REVENUE DISTINGUISHED FROM NON-TAX REVENUE

What is a Tax?

Taxes happen to be such an important source of public income that it is quite usual to talk of tax and non-tax revenues of a government. A tax is a compulsory levy and those who are taxed have to pay the sums irrespective of any corresponding return of services or goods by the government. In other words, a tax-payer does not receive a *definite and direct quid pro quo* from the government.[3] Note the word *direct* here. It is *not a price* paid by the tax-payer for any definite service rendered or a commodity supplied by the government. The tax-payers do get many benefits from the government but no taxpayer has a right to any benefit from the public expenditure *on the ground* that he is paying a tax. The benefits of public expenditure may go to anyone irrespective of the taxes paid.

A tax is a liability imposed upon the tax assessees who may be individuals, groups of individuals, or other legal entities. It is a liability to pay an amount on account of the fact that the tax assessees have income of a minimum amount and from certain specified sources, or that they own certain tangible or intangible property, or that they carry on certain economic activities which have been chosen for taxation. Thus, a tax is a generalized exaction.[4] It may be noted that a public receipt containing an element of compulsion does not automatically become a tax. In order to be a tax, the absence of a *quid pro quo* is necessary. As we shall see, the element of compulsion exists in case of some other public receipts also.

Public authorities charge prices for specific services or goods supplied by them. Here the individuals and firms etc., pay voluntarily for the purchase of these goods and services, but the element of compulsion is not always missing. If the authorities have a monopoly of the good or service in question (such as the city bus service) and if they choose to charge a price in excess of the 'competitive' one (that is the cost of production inclusive of normal profit), then the 'excess' price being paid becomes a tax for the buyers. We must, however, remember that it is not easy to separate the elements of pure price and taxation in such situations and the problem becomes more complicated when the public undertakings have a high cost of production

[3] *Quid pro quo* means something given or taken as equivalent to another.

[4] E. H. Plank (with the collaboration of J. W. Jackson), *Public Finance*, Richard D. Irwin, Inc. 1953, p. 126.

on grounds of inefficiency. Again, there may be some goods or services regarding which the 'consumers' have no choice. The authorities may thrust the supplies on them compulsorily and collectively even when all the members of the society do not want them. A municipal corporation would, in all probability, provide street lighting and other services and charge for them from every household.

This does not exhaust the list of public receipts which contain an element of compulsion. We can also mention the 'special assessments,' the fees and fines. A special assessment (or a betterment levy) is a kind of a special charge levied on certain members of the community who are believed to be the beneficiaries of certain government activities or public projects. For example, due to provision of parks or other facilities, the land values in the neighbourhood may go up. On account of the provision of irrigation facilities the productivity of the irrigated lands increases and the land prices move up. Such benefits are not due to the efforts of the property owners. They get an 'unearned increment' which the authorities would like to take away for various reasons. Being a compulsory payment, a betterment levy is like a tax. But since there is a *quid pro quo* (some people get the benefit out of a project and they pay for it), it is like a price.

Fines (such as court fines) are also compulsory payments without any *quid pro quo* but they are different from taxes because fines are imposed to curb certain offences and not to get revenue for the State. In this sense, fines are not taxes. Similarly, import and export duties may be imposed with different intentions in mind. If the intention is to get the revenue for the public treasury, they are taxes. But if the intention is to regulate the flow of imports and exports, then they change their character.

The authorities also charge fees for certain services such as registration of marriages, births and deaths. However, quite often the fees charged are far in excess of the cost of these services (except, probably, in the case of health services). To the extent that the fees charged represent the cost of services, they are like prices. But the excess charges are in the nature of a tax.

There are certain other sources of public income also which, to some extent, are like compulsory levies upon the public. One such important source of public income is the profits from paper currency and mintage. In India, for example, notes and coins up to the denomination of one rupee are printed and minted by the Government of India. The actual cost of creating this currency is

much less than its face value. The Government of India, therefore, makes a profit out of this. But this profit is not like the usual profits from other public undertakings. The public faces an element of compulsion in the sense that it has no choice but to use this currency.

Another similar source of public income is deficit financing. Ordinarily, deficit financing means an excess of public expenditure over public revenue. This excess may be met by borrowings from the market, borrowings from abroad, or the use of the printing press. In the case of borrowings from abroad, there cannot be any compulsion for the lenders; but in the case of internal borrowings there can be. The government may force various individuals, firms, corporations and other institutions to lend to it. By virtue of this compulsion, it may be able to get loans at rates much lower than what the lenders would be able to get by investing their funds otherwise. This amounts to a kind of taxation in the sense that the government does not pay to the lenders which they could get otherwise. On the other hand, instead of borrowing, the government may choose to use the printing press. When the government spends the additional funds so created, the aggregate demand increases and prices are pushed up. The government purchases away a part of resources and the market is left with smaller supplies. In other words, the government, through the use of the printing press, taxes away some resources of the market just as it could tax them away directly.

If voluntary gifts are made to the authorities, such as during a war, then such an income is neither in the nature of a tax nor a price.

The Base of a Tax

The base of a tax is the legal description of the object with reference to which the tax applies. For example, the base of an excise duty is the production or packing or processing of a specific good; the base of an income-tax is the income of the assessee defined and estimated in terms of certain rules laid down for this purpose; a gift may be defined and made a base for levying a gift-tax. Note that the base of each tax has to be defined legally and it is to be quantified for the purpose of determining the tax liability of an individual tax-payer. Each tax-payer is considered a legal entity for this purpose. Accordingly, an individual legal entity may be subjected to more than one tax. It should be noted that a tax base may have a time dimension also. For example, income-tax is usually on an annual basis and the law has to decide whether income would

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be taxed on the basis of accrual or receipt. The authorities, while determining a tax base, are expected to give due consideration to various questions like those of cost of collection, administration and effects of that tax. The exact coverage of a tax base is sought to be determired by an optimum combination of these considerations. With the passage of time, a tax base under consideration may grow or may shrink. For example, as production of excisable goods increases, the base of excise duties would be termed to have grown. Also, by law, new items may be brought under particular taxation, or the relevant provisions, definitions and rules etc. may be changed to extend the coverage or base of a tax. Thus, if new items are brought under excise duties, we shall say that the coverage of excise taxation has been extended and the base of excise taxation has been widened.

Buoyancy and Elasticity of a Tax

These terms denote the factors responsible for an increase in the yield of a tax over time. If a tax revenue increases with the growth of its base, but without an extension of the tax coverage or an upward revision of the tax rates, then the tax is said to be buoyant. It has an inherent tendency to yield more tax revenue with the growth of the base Thus, for example, with given rates of income-tax and the definition of taxable income, if yield from income-tax increases as national income increases, it would be termed a buoyant tax. Similarly, excise duties are levied on production of specified goods. If new items are not brought under these duties and the rates of existing duties remain unchanged, but the revenue from excise duties increases with an increase in the production of excisable items, we have a case of buoyancy of excise duties. It is clear that the concept of buoyancy may be applied to an individual tax or to a whole set of taxes. Numerically, the buoyancy of a tax is measured as a ratio of the proportionate increase in tax revenue to a proportionate increase in the tax base.

The yield of a tax may also go up on account of extension of its coverage or a revision of its rates. Such a characteristic of a tax is referred to as its elasticity. In other words, elasticity of a tax refers to its responsiveness to steps taken by authorities in increasing its yield through an extension of its coverage or revision of its rates. Numerically, the elasticity of a tax would be measured by as ratio of the proportionate change in its yield to the proportionate change in its coverage or rates.

Principles of Taxation

A good tax system, in order to achieve various objectives, chooses and adheres to certain principles which become its characteristics. A good tax system, therefore, is one which is designed on the basis of an appropriate set of principles, such as equality and certainty. Keeping in view the fact that the objectives of taxation are conflicting and that a compromise will have to be made, the writers on public finance have generally chosen some of the important objectives and accordingly spelt out the necessary principles which a good tax system should adhere to for achieving those objectives. In this connection, Adam Smith gave us the most important set of principles (which he called the Canons of taxation).[5]

In order to understand the nature and contents of the canons of taxation as given by Adam Smith and as added to by others, it would be helpful to keep in mind the objectives which a tax system should help in achieving. Adam Smith was basically concerned with the ways in which an economy could increase its productive capacity, and thereby achieve a higher rate of economic growth. He was of the opinion that private sector was more efficient than the public one and, therefore, the primary responsibility of economic growth should rest with the private sector. Economic growth necessitates large scale saving and investment. It is also essential that the investment should be along productive lines. All told, therefore, he was of the view that the private sector should be entrusted with the maximum possible economic responsibility for an efficient discharge of which it should be given as much freedom as possible. The only additional consideration should be the adequacy of revenue for the State (for its own maintenance, for defence, for law and order, and for social overheads) and an equitable distribution of the tax burden. With this end in view, he laid down those principles of taxation which were to satisfy these conditions.

The four canons of taxation as prescribed by Adam Smith are the following:

(1) *Canon of Equality*. "The subjects of every State ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State." This canon tries to observe the objective of economic justice. It dictates that in absolute terms the richer should pay more taxes

[5]Adam Smith, *The Wealth of Nations* (Ed. Edwin Cannan), New York, The Modern Library, pp. 777-79.

because without the protection of the State they could not have earned and enjoyed that extra income. If we interpret this principle in terms of disutility which the tax-payers suffer from by paying the taxes, it follows that the tax should impose equal marginal disutility upon every tax-payer. Two possibilities emerge in this case. If incomes are subject to constant marginal utility, then both the rich and the poor should be subjected to proportional taxation—each person paying a given percentage of his income as tax. On the other hand, if we agree with the more realistic proposition that income is subject to diminishing marginal utility, then the richer should pay a larger proportion of their incomes as taxes (that is the taxes should be progressive).

(2) *Canon of Certainty.* This canon is meant to protect the tax-payers from unnecessary harassment by the tax officials. "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person." The tax-payers should not be subject to arbitrariness and discretion of the tax officials, in which case there will be a scope for a corrupt tax administration. Adam Smith points out that if a scope for arbitrariness exists, then under such circumstances even an honest tax machinery will be unpopular. He is so emphatic about this principle as to claim "that a very considerable degree of inequality. . .is not near so great an evil as a very small degree of uncertainty."

(3) *Canon of Convenience.* The mode and timings of tax payment should be, so far as possible, convenient to the tax-payer. This canon recommends that unnecessary trouble to the tax-payer should be avoided, otherwise various ill-effects may result.

(4) *Canon of Economy.* Every tax has a cost of collection. It is important that the cost of collection should be the minimum possible. It will be useless to impose taxes which are too widespread and difficult to administer. These taxes entail an unnecessary burden upon the society in the form of additional administrative expenses. The productive efforts of the people suffer due to a wasteful use of its resources on the salaries of the officials. Realizing that the tax collections are being wasted, the tax-payers are likely to evade them.

These canons of taxation have a sound philosophy behind them and exhibit an insight into the practical experience of tax administration and its effects. However, in view of the widespread recognition of other objectives of the economic philosophy and problems of a modern State, a few additional principles were also suggested by

later writers. A brief description of these is as follows.

(5) *Canon of Productivity.* It is also called the canon of fiscal adequacy. According to this principle, the tax system should be able to yield enough revenue for the treasury and the government should not be forced to resort to deficit financing.

(6) *Canon of Buoyancy.* The tax revenue should have an inherent tendency to increase along with an increase in national income, even if the rates and coverage of taxes are not revised.

(7) *Canon of Flexibility.* It should be possible for the authorities, without undue delay, to revise the tax structure, both with respect to its coverage and rates, to suit the changing requirements of the economy and of the Treasury.

(8) *Canon of Simplicity.* The tax system should not be too complicated. That makes it difficult to administer and understand and breeds problems of differences in interpretation and legal disputes.

(9) *Canon of Diversity.* It would not be a happy situation if the State depends upon too few a source of public revenue. Such a system is bound to breed a lot of uncertainty for the treasury. It is also likely to be inequitable as between different sections of the society. On the other hand, if the tax revenue comes from diversified sources, then any reduction in tax revenue on account of any one cause is bound to be very small. However, too much multiplicity of taxes is also to be avoided. That leads to unnecessary cost of collection and violates the canon of economy.

In general, we must remember that the tax structure is a part of the economic organization of a society and should, therefore, fit in its overall economic philosophy. No tax system that does not satisfy this basic condition can be termed a good one. Over time therefore, ideas regarding what should form a good tax system have undergone an evolution. Features of a good tax system are no longer couched in traditional canons since they were devised with reference to their compatibility with the requirements of the authorities on the one hand and the needs of a private enterprise economy on the other. These days, however, the role of the state and therefore the ideas regarding the features of a good tax system have undergone a fundamental change. In the following section we would briefly discuss the characteristics of a good tax system in the light of modern economic philosophy.

Characteristics of a Good Tax System*

Tax revenue has occupied the most important place in the revenue system of almost all the governments. On account of this and other

reasons, theory of taxation has always occupied an important and leading position in the discussions of public finance. Various aspects of the problems have been brought into focus, and the discussion has not always been about one or the other aspect only. Thus, in some cases, the problem has been viewed from administrative angle; in other cases, the debate has been about the objectives which the tax system should aim at under different circumstances. Various kinds, forms, rates and timings of taxation have been analyzed and discussed. There are also analyses of the incidence and effects of various tax measures, and so on.

In the jigsaw puzzle, we should note that the problem can be considered from different angles. It would be helpful if in this connection, the following points are kept in mind.

Firstly, it should be noted that taxation is only a part (though an important one) of the total budget of the government. On the revenue side, there are items other than taxation. To consider a tax system in isolation from other items of public revenve, or from public expenditure, would be an incomplete and unrealistic attempt. The effects of any tax system are always intermixed with those of non-tax and expenditure parts of the public budget. Of course, in case taxation happens to be a major part of the public revenue, its share in the total of effects would be correspondingly greater.* Within the overall framework of the total revenue, the effects of taxation will depend upon the structure of the tax system, the tax rates, and so on. Equally important is the consideration as to what is being done on the expenditure side of the budget, since that will influence the attitudes and reactions of the tax-payers. Their reactions will be conditioned by whether they believe public expenditure to be wasteful or productive, and so on.

When we consider the effects of taxation and thereby try to figure out the characteristics of a good tax system, *it is not implied thereby that the non-tax items or the public expenditure should be ignored.* It only implies that for the sake of clarity of analysis and understanding, a step by step approach is being adopted. It must also be remembered that though non-tax items of public revenue are there, tax forms a major portion of the public revenue in most countries. Quite a substantial portion of the national income flows through the hands of the public to those of the authorities by way of taxation. Therefore, only for the sake of convenience of analysis the characteristics of a good tax system may be formulated in isolation. It is assumed here, implicitly, that the public expenditure side of the budget is being

*Objectives of taxation have been discussed in Part 2 of the book,

administered in an optimum manner, or at least it is not working against the objectives of the tax system.

Secondly, a tax system has many dimensions. We should look into its volume, composition, rates, coverage, timings of collection, mode of collection and so on in order to grasp its effects in their totality. Alternative sets of these tax-features would form alternative tax systems. Each system will have effects different from those of the other. Each system will have its merits and demerits in terms of these social and economic effects, and therefore, quite a number of these sets will claim our attention as the possible first choice. Thus, in general, it is rather difficult to evolve a tax system which is the best or ideal from every respect. The choice will have to be between different conflicting objectives and effects; a larger gain in terms of some objectives will normally entail a larger loss in terms of the others. To put it in conventional terminology, no tax system will be the "best" in an absolute sense, and a "trade-off" will have to be there as between different objectives. Depending upon our preference (or "value judgements"; we may opt for a particular tax system.

Thirdly, we must keep in mind the fact that a tax system which is theoretically the best need not be the one which can be put into practice also. In abstract theory we may talk of the marginal utility and disutility of various tax measures. But in reality, there are various difficulties, both conceptual and practical. It is not easy to translate these concepts into concrete terms. Furthermore, though in theory various tax proposals may appear very sound and convincing, quite a few of them cannot be implemented due to administrative, political or other difficulties. In theory, it is assumed that a government has an absolute right over the property of all its subjects; in practice it is not a right which can be exercised fully and without limits. Apart from this it is generally assumed that the administrative machinery is efficient and honest. In real life these ideal conditions are seldom satisfied. In a number of cases, the members of the tax-enforcing machinery may not be suitably trained to handle different situations arising in connection with the performance of their official duties. They may even be indifferent to, or ignorant of the exact legal procedures. They may go too literally by the word of the law and thereby harass the tax payers. Also, it is possible that they may even join hands with the tax dodgers. Again, some taxes, though theoretically sound, may involve a heavy cost of collection. In some countries, there may be long drawn legal procedures (such as passing of the tax measures by legislative bodies) preventing the government from changing its tax policy quickly and easily. In actual practice, therefore,

the government has to think of these various problems while working out the best possible tax system in the country. It will generally settle for a compromise between these conflicting considerations and will therefore end up with a tax system which is not a perfect or ideal one. Furthermore, it is conceivable that even the government may fail to make correct estimates as to the effects of different tax-measures, and their appropriate rates. This limitation further supports the earlier statement that an ideal tax system is not likely to be adopted in practice.

Fourthly, the attitude of the tax-payers is an important variable determining the contents of a good tax system. It may be assumed that each tax-payer would like to be exempted from tax paying, while he would not mind if others bear that burden. In any case, he would want his share to be within the general level of tax burden being borne by others. If this is not so, he will feel exploited. To put it differently, it is essential that a good tax system should appear equitable to the tax-payers. Similarly, overall burden of the tax system is of equal importance. The attitudes of the tax-payers in this regard are influenced by a host of other factors like the political situation (such as war or peace), natural clamities like floods and droughts, economic situations like prosperity or depression and so on.

Fifthly, it is well-known that changes in a tax system can be brought about only slowly and in stages. Even if it is decided to have an entirely new tax system the authorities cannot suddenly disrupt the whole old system. They have to gear their tax-machinery to the new system. On account of the above mentioned limitations, the authorities cannot hope to satisfy all the objectives or considerations, and have to be satisfied with a compromise between them.

In general, a good tax system should run in harmony with important national objectives and if possible should assist the society in achieving them. It should try to accommodate the attitudes and problems of the tax-payers and should not lose sight of the administrative practicability or the goals of social and economic justice. It should also yield adequate revenue for the treasury and should be flexible enough to move with the changing requirements of the State and the economy. The dynamism of the tax system is all the more relevant for a developing economy where the structure and rates of taxes have to be constantly reviewed.

We may say that the interests of the administrative machinery, the economy, the State and the individual tax-payers can be conflicting and a good tax system will try to accommodate them all in the best possible manner.

A good tax system recognizes the basic rights of the tax-payer. The tax-payer is expected to pay his taxes but not undergo harassment. With this end in view, tax laws should be simple in language and the tax liability should be determinable with certainty. The mode and timings of payment should suit the convenience of the tax-payer to the extent possible. At the same time, a tax system should be equitable as between different tax-payers. It should be progressive so as to levy an equitable burden on all.

Developed free market economies are subject to cyclical fluctuations in their incomes and employments. A good tax system should be flexible enough to counteract these cyclical fluctuations. In the underdeveloped countries, on the other hand, the main problem is not that of cyclical fluctuations, but of the need to unleash the forces of economic growth and productivity. For this all the possible sources of savings and capital accumulation should be exploited. Paucity of private savings and investment necessitates a greater reliance upon the budgetary savings as the main source of capital accumulation. In the private sector, the tax system should encourage the consumers to go in for durable consumption goods. This will reduce their expenditure on consumption items over time and release larger amounts for savings. Heavy import duties should be used to curb import of luxuries and cut the demonstration effect. Within the economy, the demand for luxuries should be reduced while the consumption and production of health-giving and efficiency-producing goods should be encouraged.

Another problem that a developing economy like India faces is that of regional disparities. Tax measures should be so devised as to counteract this tendency and bring about a more equitable economic growth. In the process of economic growth, a developing country is likely to face the problem of inflation. A good tax system should help in counteracting inflationary forces. It should be designed to discourage unnecessary consumption and to help in boosting up production along desired lines.

5 THE DIVISION OF TAX BURDEN—I

INTRODUCTION

Each big problem should be split up into portions and studied bit by bit in order to have a clarity of understanding and to keep the arguments in order. In the same manner, though the issue of tax burden cannot be separated from the expenditure side of the budget, we shall study it without bringing the expenditure side into account.

While studying the burden of taxation and its appropriate division members of the society, we shall keep in mind a few facts.

Firstly, we should remember that a tax by definition is a compulsory payment and has no *quid pro quo*. In other words it is to be distinguished from the *price* which the authorities might be charging for a good or a service.

Secondly, a tax has its initial impact, but it is not necessary that its incidence must rest at the point of impact.[1] This means that the tax may be paid in the initial stage by those members of the community who do not bear the final money burden of it. They may collect the tax amount—partially, fully or more than fully—from other members of the society. In other words, while discussing the distribution of the tax burden amongst the members of the society, we are to look at the incidence of the tax rather than its impact. For example, it will be totally wrong to say that an excise duty or a sales tax on a good is borne by the producer or the seller simply because the government is collecting the tax at that point. Whether or not it is passed on to the consumers depends upon the demand and supply elasticities of the good in question.

Thirdly, every tax has its own *effects* which are generally not confined to the losses or benefits to only the direct tax-payers or upon whom the incidence rests. There are effects in terms of employment, income stabilization, and so on which it may not be possible even to quantify—let alone determine their distribution amongst the members of the society.

When we discuss the distribution of the tax burden amongst the

[1]Impact of a tax refers to its point of collection; incidence refers to the final source from which it is pai d.

members of the society and work out the principles upon which such a distribution ought to be based, we have in mind only the burden of the incidence of taxation and no reference is made to the final *effects* of any tax proposals. By adopting this approach we do not imply that such repercussive effects are not there; the purpose is only to keep the analysis at a simple and manageable level. Again, it is assumed that the objective of taxation by the government is just to raise a certain amount of needed revenue and it is to be decided how best it could be raised so as to conform to certain criteria of distributing the resultant burden amongst the tax-payers. It is assumed that the tax revenue is not being raised with any other primary objective—though while comparing and choosing between different tax principles, we shall have occasion to refer to these effects also.

This assumption, we know, may not be true in many cases. Apart from the revenue raising purpose, the tax proposals might be designed to fight cyclical fluctuations in employment and income in the country. They might be designed to generate necessary savings on the part of the public so as to provide a source of capital accumulation. Or the authorities might plan to effect savings and capital accumulation themselves through public budgets. Similarly, tax proposals might be designed to push productive resources, especially capital, from relatively more to relatively less prosperous areas in order to bring about a more balanced regional development. Still another objective could be to make the foreigners pay for the revenue through customs duties. To the extent that happens, the question of apportioning the burden of the tax within the community members does not arise.

We shall see that there are three bases on which the tax proposals are generally developed and suggestions are made for the distribution of the tax burden as defined above.

Firstly, there are some theories according to which there need not be any relationship between the taxes paid and benefits flowing from the authorities to the tax-payers. In this connection, there are two approaches which we shall have occasion to see. The first one gives us the *Socio-Political Theory* and the second one yields the *Expediency Theory*.

Secondly, there is an approach which links the tax liability to the State activities. It maintains that since State is providing goods and services to the members of the society, it should charge for them. This approach tries to provide us simultaneously with a justification for imposing taxation (the State is providing the services and has a right to charge for them) and a principle for apportioning the tax

burden.[2] Here again there are two theories in this linking process. The first one links the tax liability to the benefits which the tax payers are supposed to be receiving from the State activities and is called the *Benefits-Received Approach.* In the second case, the tax liability is linked to the cost of providing the good or service to the community by the State and is called the *Cost-of-Service Approach.*

The *third* basis of apportioning tax burden links the tax liability to the paying capacity of the tax-payers and is referred to as the *Ability-to-Pay Approach.*

We shall take up these approaches one by one.

I (A). The Expediency Approach

This approach tries to assert that in reality every tax proposal not only must pass the test of practicability, it must be the only consideration weighing with the authorities in choosing a tax proposal. To paraphrase this proposition, it would mean that in the choice of various tax proposals, the authorities need not consider various economic and social objectives or the effects of a tax system. This proposition has a truth in it, but only a negative one. In practice every legislature and every authority is pressurized by various economic, social and political groups to orient its taxation policy in certain directions. Every group would try to resist a change that goes against its interests. The authorities, in many cases, have to adopt certain policies simply because there are pressures to that effect. Also depending upon the changing political strength of different economic groups, the authorities are likely to reshape the tax structure. It is also clear that while choosing and imposing a tax, the authorities would be making a great blunder if they lose sight of the administrative feasibility, the cost of collection, and so on. They would in general want to pluck the goose 'where the feathers are thickest' and there is a 'minimum amount of squawking'.

However, as we can easily see, to build up an entire tax system solely on the considerations of expediency must be full of pitfalls. In cases, such a tax policy may be able to yield certain good results like contributing to the equality of income distribution, or reducing regional disparities, but such results would be purely accidental and not the fruits of any thoughtful effort or plan.

A taxation system has a role to play in helping the economy. If anything, it should be anti-cyclical, pro-equity and should contribute

[2]Harley L. Lutz, *Guideposts to a Free Economy*, New York, McGraw-Hill Book Co., 1945. Ch. IX.

towards augmenting welfare in general. But when the tax system is worked out without reference to these objectives and policies, its role is essentially whittled down to nothing. Not only it is not likely to help the economy, it will quite often be positively harmful. It will on many occasions be a destabilizing factor and would be a source of increasing inequalities and socio-economic injustice.

As stated above, practicability is an essential consideration in every tax proposal. If a tax cannot be collected, it is ridiculous to impose it. But of different practicable taxes, and different practicable rates, the choice has to be in terms of their possible effects on the working of the economy. By itself, this approach is not at all able to help the authorities in deciding as between different practicable taxes. And, of course, those who are going to suffer by the imposition of a new tax or by a change in any existing tax are bound to advocate that the tax under consideration is not practicable. It must be remembered that within the limits of practicability, the authorities have a lot of maneourvability regarding the choice between different taxes. They must not lose sight of the considerations of equity, economic stabilization, growth, regional imbalances, and so on.

I(B). The Socio-Political Approach

In contrast to the Expediency Approach, Adolph Wagner advocated an approach in which not the expediency but final social and political objectives are the deciding factors.[3] Wagner, like most Germans of those days, did not believe in individualist approach to a problem. He wanted that each economic problem should be looked at in its social and political context and an appropriate solution found thereof. The society consisted of individuals, but was more than the sum total of its individual members. It had an existence and entity of its own which needed preservation and taking care of. Accordingly, a tax system should not be designed to serve the needs of the individual members of the society, but should be used to cure the ills of society in so far as it is possible. Wagner, in other words, was advocating a modern welfare approach to the whole problem of evolving and adopting a tax policy. He was specifically in favour of using taxation for reduction of income inequalities and to achieve this objective, he advocated that all small incomes should be exempted from taxation.

He maintained that private property and inheritance were there be-

[3]Adolph Wagner, *Finanzwissenchaft*, Leipzig, 1880, Vol. 1, para 27.

cause the State was permitting them to be there and not because of any God-given right to the concerned individuals. The State, therefore, had the right to control the ownership of property and the right to inheritance in a way it liked in the interests of the society as a whole. Wagner's ideas, though much criticized at that time, are now the hall-mark of modern States' fiscal policies. Taxation in a modern State is generally designed to curb inequalities arising out of the right to property and inheritance. Progressive taxation is the rule rather than the exception. In the modern context we may extend Wagner's stand by including other economic and social objectives of the society in which taxation could be a helpful tool. For example, there is, these days, a need to curb cyclical fluctuations unemployment, production of undesirable goods and services, monopolistic and restrictive trade practices, hoarding, and so on. There is also the need to bring about a more balanced growth as between different regions. That way, the Socio-Political Approach is far more meritorious than the Expediency one.

Both the Expediency Approach and the Socio-Political Approach have their merits, but they cannot be advocated as the basic policies in a tax system. At the most they act as limitations upon the possible tax structure that might be adopted. Equity, in whatever way it is defined, has to be the hall-mark of any sound tax system. Without it, not only the tax system losses its fairness as between different members of the society, it becomes a source of social, economic and political unrest as well. In this connection, the Royal Commission of Taxation (Canada) in its Report asserts that "The first and most essential purpose of taxation is to share the burden of the State fairly among all individuals and families. Unless the allocation of the burden is generally accepted as fair, the social and political fabric of a country is weakened and can be destroyed. History has many examples of the severe consequences of unfair taxation. Should the burden be thought to be shared inequitably, tax-payers will seek means to evade their taxes. . . . We are convinced that scrupulous fairness in taxation must override all other objectives . . . . . "[4]

It follows that the considerations of fairness can be ignored only at a risk to the government and the society. But to say that fairness should be the hall-mark of any tax structure is only an inadequate statement. For, on the one hand, there is no agreement as to what constitutes 'fairness' and on the other, there can be a conflict between

[4]R.W. Houghton (Ed.), *Public Finance*, 2nd edn., Penguin Modern Economic Readings, 1973, p.143.

the objective of fairness (in whatever way it may be defined) and other objectives like growth, stabilization, etc. In general, fairness is to mean an equitable distribution of the tax burden. "Equity has two dimensions. Horizontal equity requires that individuals and families in similar circumstances bear the same taxes. Vertical equity requires that those in different circumstances bear appropriately different taxes."[5] The Royal Commission on Taxation (Canada) maintains that equity is a question of "belief rather than of fact. We can do no more than recommend what we believe to be fair." We shall consider the question of equity more specifically in the Ability-to-Pay Approach.

This brings us to the second set of theories, namely, the ones which link the tax burden to either the benefits received by the members of the society or to the cost of providing the State services.

II (A). The Benefits-Received Theory

This theory proceeds on the assumption that there is basically an exchange or contract relationship between the tax-payers and the State. The State provides various goods and services[6] to the members of the society and they contribute to the cost of these supplies in proportion to the benefits received. To use J.S. Mill's terminology, the relationship between the tax-payer and the State is in *quid pro quo* terms. It is an exchange relationship. In this approach the problems of *bringing about* equitable distribution of income and wealth are ignored. Instead, the benefits-received approach itself is used as a standard of justification for imposing the taxes in a particular way. Also this approach ignores the possible use of the tax policy for bringing about economic growth or economic stabilization in the country. The only aspect covered here is the way in which the goods and services should be supplied and financed privately and publicly.

Here we may divide the services supplied by the State into two categories. The first category consists of those services to which the principle of exclusion does not apply. In this case every member of the society consumes these services and therefore should be contributing to the State revenue in accordance with the benefits received. But the other category is the one where the tax-payers have the option to accept or reject the services supplied by the State. Here a market relationship is established between the subjects and the State. Actually, in the latter case, the members of the society pay the fees

[5]R.W. Houghton, *op. cit.*, p. 143.

[6]We shall quite often use the term, 'State services' to cover both goods and services supplied by the State.

or the prices and not the taxes in the strict sense of the term. Taxes are by definition compulsory payments while in this case the members of the society embark upon voluntary exchange of their purchasing power with the services supplied by the State. This implies an unnecessary and undesirable limitation upon the scale of State activities.

The benefits-received approach has a long-dated origin and its roots lie in the contract theory of the State. Professor Edwin R. Seligman surveys the development of this theory as contributed by various authors and thinkers.[7] The theory was vogue with German, French and other writers like Grotius, Hobbes, Locke, Hume and Rousseau. According to this general approach, the main theme was that the subjects of a country had a contract with the State for the protection of their lives and property to which end the State was providing various goods and services.

Now there are some problems in this approach which had to be looked into and solved. How do we estimate the benefits which an individual tax-payer derives from the expenditure undertaken by the State? Moreover, since the relative tax liability of different members of the society would depend upon their relative benefits, how to compare these benefits? Is it not possible, that through taxation the distribution of income and wealth is modified so as to yield greater total benefit to the members of the society from the same national income?

In order to make sense, this theory has to assume that the income and wealth distribution in the country is already a proper one and no change in it is called for. Given this state of affairs, then, some process of knowing and estimating the benefits to individual members of the society is to be taken up.

Now, since benefit is ultimately a subjective thing, there is no scientific way of measuring it. At the most it may be possible to adopt some commonsense plausible method. For example, one such method can be to treat income as the indicator of the benefits received. It may be assumed that without the protection of the State, the economy just cannot exist and accordingly it may be inferred that the benefits which each member of the society derives from the State are in proportion to his income. Such an inference would lead to policy recommendation of proportional taxation. About the same thing was being said by Adam Smith when he said that each individual ought to contribute to the public revenue according to his

[7]Edwin R. Seligman, *Progressive Taxation in Theory and Practice*, 2nd edn., American Economic Association, Princeton.

ability. Smith equated the relative ability to pay of the tax-payers with the relative incomes which they respectively enjoyed under the protection of the State. Thus, in due course, the benefits approach gradually degenerated into a form where it was basically a payment for the protection from the State.

It is, of course, interesting to note that even this narrow interpretation was subject to variations. Thus, while Rousseau and Sismondi argued that the rich needed greater protection of the State, John Stuart Mill and others thought that the poor were in greater need of protection. Thus, while one group of thinkers was coming to progressive taxation, the other was in favour of regressive taxation.

In the nineteenth century and early twentieth century, however, we also find the use of the benefit approach for showing the optimum State activity and the optimum distribution of tax burden. In other words, there was an attempt to simultaneously estimate the desired level of supply of goods and services by the State and the corresponding distribution of tax between the members of the society.

The attempt was to view the taxes as a price for the State services. For each commodity the consumers have a demand schedule, showing various quantities that would be demanded at respective prices. Similarly, it was maintained that the tax-payers would demand different amounts of State services at different levels of taxation. In the same manner, the State had a supply schedule of State services. And the tax level which equated the demand for and supply of State services was brought about by the interaction between demand and supply forces like it happens in the market. In this connection, in 1880, U. Mazolla, an Italian, asserted that there is a basic difference between the characteristics of private and public goods in the sense that the latter are all shared by the consumers.[8] In other words, the principle of exclusion does not apply in their case. Accordingly, justice would not demand that each tax-payer pays the same price for the public goods; instead the tax liability of different tax-payers should be in proportion to the relative marginal utility of the State services to them. In the process, each tax-payer would equate the marginal utility from his expenditure on the public and private goods. On the other hand, in 1887, Emil Sax, an Austrian economist, made a distinction between 'personal collective wants' and 'collective wants proper.'[9] The principle of exclusion applies to

[8]R.A. Musgrave and Alan T. Peacock (Eds.) *Classics in the Theory of Public Finance*, International Economic Association, Macmillan and Co., 1958.

[9]*Ibid.*

the former and in their case fees or taxes can be charged according to the services received. But in the latter case, the principle of exclusion does not apply. No individual consumer can be left out of the benefit of these services. Accordingly, here the tax-payers have to agree as to what is the relative benefit which they derive from their respective consumption of public services. Sax advocates that a good proxy of the measure of this relative benefit would be the proportional income tax.

In 1896, Knut Wicksell (a Swedish economist) put this theory on an ethical basis.[10] This system of imposing taxes is good because it leaves the tax-payers free to opt out of a State service. The basic tenet of his thesis is that tax system should be based upon voluntary and unanimous action. However, we note that if tax burden is to follow only the voluntary approach, its role to bring about equitable distribution of income and wealth is ruled out. Wicksell admits that in order that his theory be applicable, income distribution has to be an equitable one in the first instance.

In 1888, Antonio de Viti de Marco (another Italian economist) made an assumption similar to that of Sax that the members of the society consume public services in proportion to their incomes.[11] This assumption should have led him to advocate proportional taxation. But he also brings in the question of marginal utility of income to the tax-payers. Since larger incomes bring in lower marginal utility, the richer citizen ought to pay more for the same service. De Marco, like Adam Smith, then brings in a mixture of the benefit approach with that of the equitable distribution of sacrifice which is represented by ability-to-pay approach. He is not asserting that the richer people secure greater benefit from State services, as is maintained by some others. The richer, therefore, are not to pay more taxes because of greater benefits, but because of lesser sacrifice involved in paying taxes. They are to pay more taxes because proportional taxation hurts the poorer more and the richer less. It is the equitable distribution of sacrifice which leads us to recommend that the richer sections should pay more taxes.

The most formal and rigorous formulation of the benefits-received approach was provided within a framework of voluntary exchange theory of public finance by Erik Lindahl of Sweden in 1919.[12] He

[10]Musgrave and Peacock, *op. cit.*

[11]*Ibid.*

[12]Erik Lindahl, *Die Gerechtigkeit der Besteuerung*, Gleerupska, Lund, Sweden, 1919.

discusses the problem in the context of two tax-payers who have the liberty to reveal their preferences for State services against the corresponding tax liability. In other words, it is a kind of voluntary exchange between the taxes paid and the State services received which is to be determined on the basis of the preferences or demand schedules of the tax-payers for the State services. Lindahl took the case of two individuals by assuming that they constitute the society and then tried to work out the optimum level of State activities and the corresponding equilibrium division of the tax burden between the two individuals.

Lindahl ignores the problem of equitable distribution of income as such and keeping that distribution as it is, he proceeds to discuss the solution of three problems. The first one is the decision about the extent of the State activity—that is, its expenditure and taxation level. The second one is that of allocating the total public expenditure amongst various goods and services. The third one is the allocation of the tax burden amongst the tax-payers.

Lindahl's theory has been explained by Howard R. Bowen through

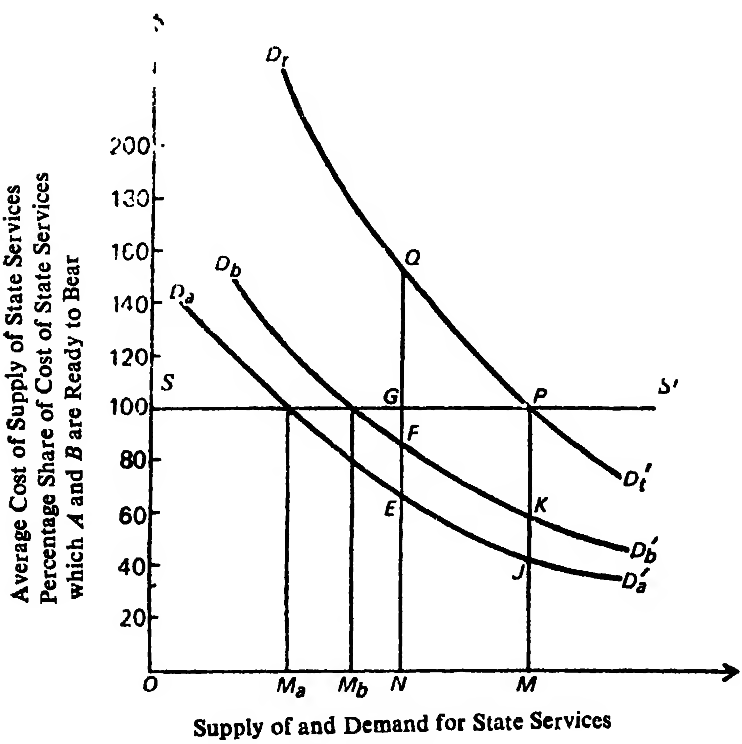


FIG. 5.1

the means of a simple diagram[13] (*see* Fig. 5.1). Let SS' be the supply schedule of the State services in the sense that this is the per unit cost of the corresponding supply of State services. Let there be two members of the society, A and B. A has a given demand schedule for the public services. Keeping in mind the fact that whatever be the supply of State services, they would be consumed jointly by both A and B, Mr A agrees to contribute different proportions of the cost of supplying those services to the community. Larger the proposed supply of the State services, smaller is the part of the per unit cost which he is ready to bear. Of course, whether his absolute contribution would increase or fall depends upon his elasticity for demand for the State services. Thus, for a supply of less than OM_a units of State services, Mr A is ready to bear more than the full cost of the State services. For supplies larger than OM_a his desired contribution is smaller—for example, he is ready to contribute only NE per unit (out of the total cost of NG per unit) of the State services when the supply of State services is equal to ON. In the same manner, the demand schedule of the individual Mr B is found out. Now since, for example, for a supply of ON of State services to be jointly consumed by both A and B, Mr A is ready to contribute NE and Mr B is ready to contribute NF, therefore, the State can collect a tax revenue of NQ per unit of State services. The point Q therefore lies on the combined demand schedule for State services. In this way, by vertical addition of the two demand schedules, we can get the community's demand schedule for the State services, namely $D_tD'_t$. Now note that at ON, the cost of supply is only NG per unit. Since the State is not interested in making a profit out of the supply of services, it respects the desire of the tax-payers and increase the supply of State services. But for increased supplies, each tax-payers is ready to contribute a smaller proportion of the cost. Eventually, we find that for a supply of OM of State services, the combined contribution by the tax-payers ($MJ+MK=MP$) equals the cost of supply. This is the position where the combined demand curve $D_tD'_t$ intersects the supply curve SS'. Thus equilibrium, on a voluntary exchange basis, is achieved at this position where the State supplies services equal to OM at a per unit cost of MP out of which Mr A contributes MJ per unit and Mr B contributes MK per unit.

If the State services are subject to the law of increasing or diminishing costs, so that the supply curve is no longer horizontal, no basic

[13]Howard R. Bowen, *Towards Social Economy*, Rinehart and Co., New York, 1948, p. 177.

difference to the argument will be made. The only result will be different proportions of taxes contributed by the tax-payers.

Thus Lindahl's theory (as explained through Bowen's diagram) tries to provide an answer to two out of three questions posed above. It shows the optimal level of state activity and it also provides an answer to the question of allocating tax burden amongst the tax-payers. Lindahl's argument can easily be extended to cases of more than two individuals and more than two state services. For this, however, complex mathematical techniques are needed. For a general discussion the technique is extremely cumbersome. In formal terms, we have to have the relevant sets of cost functions of state services, and the demand functions of each tax payer for each state service. The constraints covering the interdependence of these functions have also to be specified along with specification of each individual function. Further, each of these functions has to be a stable one. Obviously, all these prerequisites cannot be easily satisfied which makes Lindahl's (and for that matter any such complicated theory) difficult to apply especially because there are bound to be information gaps in our specifications.

Clearly, Lindahl's solution suffers from certain inherent limitations. *Firstly*, it starts with a case of two individuals in which each individual bases his demand schedule for the state services on the assumption that the contribution of the other individual to the cost of supplying state services is given. Such a state of affairs creates a situation analogous to the determination of price under duopoly and is not likely to yield a stable solution without highly rigorous assumptions, and that too would depend upon the position which is assumed to exist at the beginning and our assumptions regarding the bargaining strength of *A* and *B*. *Secondly*, even if all the functions are specified and stable, the actual solution becomes so cumbersome as to be of very limited practical value. *Thirdly*, it is totally unrealistic to assume that we can ever come to know the preferences of individual tax-payers. By definition, public goods to which the principle of exclusion does not apply, are expected to be in the public sector. Since no individual can be denied the use of such public goods, each tax-payer would have an inherent tendency to understate his preferences for such state services. *Fourthly*, in actual practice, individual tax-payers hardly get a chance to express their preferences. Their preferences are expressed on their behalf by the legislatures or the executive authority and such a system is bound to be an imperfect one. *Fifthly*, Lindahl's theory assumes that the distribution of income is already optimal. The non-validity of this

assumption indicate the fact that the demand schedules of individual tax-payers cannot be expected to represent true needs and preferences of the society. *Lastly*, Lindahl's theory is based on the assumption that the state activities are financed only through a form of taxation and not through public borrowings and use of the printing press etc.

Limitations of the Benefits-Received Approach

(1) The main difficulty in this approach is that basically the contributions by the members of the society to the State Treasury for the provision of State services are not strictly taxes. *They are in the nature of prices* which the members of the society *voluntarily* agree to pay for the public services rendered to them. Even when the decisions regarding the supply of public services and the respective contributions by the members of the society are taken not on individual basis, but on the basis of some representative body such as the Parliament, or on a majority voting basis, prices only partially acquire the character of taxation (i.e., compulsory payment without any necessary *quid pro quo*).

(2) A very important difficulty is that of *measuring the benefits to* the individual members of the society. Benefit is ultimately a subjective thing and cannot be estimated directly. Any proxy that may be taken to represent the benefit received will be subject to discussion. And quite often diametrically opposite results may be arrived at on account of this difference in the interpretation of the benefits. Thus, some authors take income as the representative of the benefits received. In itself, this is a questionable index especially if we do not look into the expenditure pattern of the State. For example, it would be wrong to maintain that the benefit of State services is the same for the individuals one of whom gets a State pension of Rs 100 per month and the other earns that amount by his own labour.

(3) Throughout the discussion on the benefits received from the State services, it is assumed that the *benefits are independent of each other*. It means that the benefit that any individual enjoys depends only upon his direct receipts of the benefits from the State and that it makes no difference to him as to who else is getting the benefit and how much. This, we believe, is a wrong statement. We all know, for example, that the satisfaction that one derives from his income depends not only upon his own absolute income, but also equally upon the incomes of others. A rich person may feel better on account of the fact that his income is far more than those of the others. Or he may feel bad because there is poverty around him. It is highly unlikely that he would be totally indifferent to the

incomes received by others. In the same manner, the benefits derived from the State expenditure do not depend only upon the absolute amount received by a given individual, but also upon how he views the shares of others.

(4) This principle falls foul of all welfare activities of the State which bring in any distributional changes. "For example, the benefit derived by an old age pensioner from his pension is definite enough, and the benefit of service principle would require him to return it to the public treasury in the form of a special tax."[14] Though, quite erroneously, this principle assumes that the distribution of income is already proper, still such a proper distribution might be the result of the State activities themselves. If the State taxes according to the benefits received, the net result might be an improper income distribution. This assumption, therefore, that the income distribution is already proper is obviously erroneous. An important objective of most fiscal policies is to bring about a shift towards what is considered a proper income distribution. The benefit principle militates against this possible objective. The relationship of the State with its citizens is reduced to a semi-commercial level only.

(5) It is equally questionable to assume that the income received by a member of the society is directly connected only with the benefits received from the State. The exact relationship between the income of an individual and the valuation of the benefits received from the State services is not always clear and quantifiable. Looked at from one angle, it may be said that income is subject to the law of diminishing marginal utility and as a result the richer people derive proportionately lesser benefit from the State activities. It may also be asserted that the poor are in greater need of the State protection so as to be saved from exploitation by the rich. That is why the State has to enact all kinds of labour legislation and enforce the same. The other view here could be that the richer sections can enjoy their wealth and income only because of the State protection of their "rights." If the State derecognizes their rights, they will lose this privilege. Therefore, the richer sections need and get larger measure of State protection. Also, in practice, we know that enactment of various laws and traditions enable the richer classes to have much wider and profitable opportunities of acquiring additional income. The opportunities to the poor are always inadequate.

(6) It must be remembered that a society is not just the summation of its individual members. As German writers have the tradition of

[14]H. Dalton, *Public Finance*, pp. 89-90

insisting upon, a society is an organic entity, having a soul of its own in addition to being the sum total of its members. Accordingly, there are many benefits and cost which cannot be ascribed to any particular individual or a group of individuals. The existence of the society and the nature of some goods is such that there are "externalities" of those goods. Mention has already been made of such externalities while discussing public goods. The problem therefore remains that of assigning the net benefits and the tax burden. There are certain State activities, such as those helping the economy in its economic growth, which cannot be quantified at all—much less ascribed to any particular sections of the society.

(7) In a number of cases people suffer from a lack of complete knowledge. A particular State service may be of great help to the society and even to the individual tax-payers, but it may not be widely known. In India, for example, quite a few villagers may not be appreciating the benefits of small-pox vaccination and similar other health measures, out of their ignorance. It will be misleading on our part to assume that these villagers would be *voluntarily* opting for the provision of these health measures and would also offer to pay for the same.

(8) A modern economy is generally faced with the problems of economic growth (in the case of underdeveloped economies) and/or of stabilization (especially in the case of developed economies). Benefit approach is not able to guide the government in this sphere because the benefits accruing to the economy as a whole cannot be apportioned amongst the individual members of the society.

(9) The benefits-received theory does not become more acceptable even if we take up a more rigorous and formal statement of Erik Lindahl. Lindahl's approach assert that each tax-payer should reveal his true preferences. *Firstly*, it may not happen especially when each tax-payer finds that it may be possible to achieve a better position by showing a lesser demand for State services (or public goods). Ultimately, it becomes a question of the strategy and bargaining power and no single equilibrium solution becomes available. *Secondly*, the problem becomes all the more complicated when the number of tax-payers is more than two, as is almost always the case. Here with a large number, any individual tax-payer will find that his noncontribution to the public revenue is not going to affect the State expenditure or the supply of public goods proper. Accordingly, each tax-payer has the tendency to evade tax and conceal his true preferences. And unless true preferences of the members of the society are known, decisions regarding the nature and extent of the

public services cannot be taken; nor can the allocation of the cost of services be made. *Thirdly*, in some cases, the whole approach can lead to very absurd result. For example, realizing that his contribution as a tax-payer would not affect the defence effort of the country, each tax-payer might refuse to contribute for it. Should it mean that the *true* preference of the society is not to be protected against foreign aggressions? Obviously, we have been led to a wrong conclusion by the concealment of true preferences by the society.

(10) Wicksell and Colm emphasize the basic fact that the determination of the State budget is through a political process and not through the market mechanism of demand and supply forces. The State organization might work through an elected legislature or through a bureaucracy or some such other method, but it is certainly not a market process where demand and supply forces will determine the extent of each service and its price to be charged from the individual members. Furthermore, Colm also points out that apart from the fact that the State budget is determined through a political process, an individual also changes his *outlook* while taking decisions about the taxes. In the latter case he does not go by his own individual interest only. He has also in mind the political factors including what type of society he wants to have around him and the way in which tax contributions can help in its building.[15]

(11) A general objection to the whole approach will be the non-recognition of the objective of equity in taxation. Though it is occasionally mentioned it is not generally accepted as a part of this theory.

(12) Another general limitation of this theory is that the relationship between the government and the public is reduced to the one of a semi-commercial nature. Most basic functions of a good government like helping the needy, protecting the helpless, and so on are ruled out according to this theory.

(13) This approach does not tell us what to do if the tax collections based on benefits received do not match the government's expenditure. Should the government then resort to budgetary savings or market borrowings? Also no interconnection between tax collections and other sources of government revenue like gifts, profits from currency etc., is brought to the forefront.

(14) Different economic units are interdependent in an economy through their mutual economic transactions. As a result, the benefits or losses of particular government activities seldom remain confined

[15]Gerhard Colm, *Essays in Public Finance and Fiscal Policy*, Oxford University Press, New York, 1955, pp. 32-33.

to the first points of impact. Almost invariably there will be rounds of benefits or losses to additional economic units not covered by the first impact. This approach is not advocating taxing the secondary tertiary and later beneficiaries.

II (B) Cost-of-Service Approach

This approach is very similar to the Benefits-Received Approach. It emphasizes the semi-commercial relationship between the State and the citizens to a greater extent. The implication is that the citizens are not entitled to any benefits from the State and if they do receive any, they must pay the cost thereof. We notice that the defects of this approach are very similar to those of the benefits-received approach and therefore we shall mention them very briefly.

In this approach the State is being asked to give up its basic protective and welfare functions It is to scrupulously recover the cost of the services and therefore this approach, unlike the benefits-received approach, specifically implies a balanced budget policy. In the process, the State is not to be concerned with the problems of income distribution. No effort is to be made to improve income distribution; and no notice is to be taken if the policy of levying taxes according to the cost-of-service principle deteriorates the income distribution further. Quite a few sources of public revenue will be ruled out according to this approach, including for example taxes on windfall gains, capital gains, unearned increments, inheritance, gifts, expenditure, as also excise duties and sales taxes etc. Furthermore, by definition, the welfare activities of the State are ruled out including all sorts of relief activities. In a modern economy, this principle has a very limited application with reference to only a few State activities.

This principle is also full of many conceptual difficulties. *Firstly*, we have the problem of measuring the cost of State services and assigning them to the proper beneficiaries. Quite a few of the State activities are in the nature of those goods (or services) to which the principle of exclusion does not apply (no one can be denied a share in their consumption) but the cost of the service cannot be apportioned between different members of the society. No exact proxy is available for such apportionment, such as the income level, size of the family, etc.

Secondly, in many cases it is not possible to have a conceptual clarity of the cost measures. Suppose certain State services are being produced inefficiently and therefore at higher costs. Should the cost of inefficiency be also passed on to the consumers?

Thirdly, there are quite a few State services which have externali-

ties. These externalities appear in the form of social benefits and social costs. Should the State confine its attention to only the commercial costs as the private entrepreneurs do? Or should it take into account the externalities also and estimate the net social cost in determining the tax liability? It will be a perilous posture if the State adopts only a pure commercial stand. In such a case it might pursue certain policies which disrupt the life and growth of the economy. It might jeopardize the process of savings and capital accumulation; it might hasten the exhaustion of the mineral wealth; it might lead to the denuding of the forests, and so on. It will be a highly objectionable practice since the State is the custodian and protector of not only the existing generation, but of the future generations also.

A very serious question which the State has to decide is about the *extent* and *nature* of State services to be provided to the citizens. Is the State to decide the scope of its activities on its own and impose the burden of the cost of such services upon the tax-payers irrespective of their preferences? Or is it to adopt some means whereby it ascertains the wishes of the society and proceed accordingly? Just as the first alternative is obviously not to be recommended, the second one throws up its own problems such as the appropriate methods of ascertaining the true preferences of the society. As the discussions of the welfare economists tell us, there is no foolproof and practical method available to us for this purpose; and it is also possible that our estimation procedures may end up with totally wrong inferences.

It must be remembered that the above mentioned limitations are not necessarily applicable in all cases. There are circumstances in which ordinary ethical considerations dictate that the particular beneficiaries should be taxed and where it is a feasible proposition also. For example, when the idea is to develop an area through provision of irrigation facilities, or develop a residential colony, but the objective is *not* to aid any specific section of the society, then it would be reasonable to impose a special assessment or a betterment levy to cover the cost of the project. It may here be possible to identify the beneficiaries in a more or less certain way and assign amongst them the proportionate cost of the project. However, if the objective is to *help* a weaker section of the population, this principle of levying taxes breaks down. Actually, one of the greatest drawbacks of this approach is its inapplicability to welfare propositions (or objectives).

6 THE DIVISION OF TAX BURDEN—II

III. Ability-to-Pay Approach

This approach considers the tax liability in its true form—a compulsory payment to the State without *quid pro quo*. It does not assume any commercial or semi-commercial relationship between the State and the citizens. According to this approach, a citizen is to pay taxes because he can, and his relative share in the total tax burden is to be determined by his relative paying capacity. This doctrine has been in vogue for at least as long as the benefits approach. A good account of its history is found in Seligman.[1] It received a good deal of support from the socialist thinkers who were eager to put the ideas and concepts of justice and equity into practice. However, the doctrine enjoyed a good measure of support from non-socialist thinkers also. It became a part of the theory of welfare economics.

The basic tenet of the ability-to-pay doctrine is that the burden of taxation should be shared amongst the members of the society so as to conform to the principles of justice and equity, and that this equity criterion will be satisfied if the tax burden is apportioned according to their relative ability to pay. In this connection, however, we should remember the following points :

Firstly the doctrine of ability-to-pay is also combined, in certain cases, with the objectives of maximum welfare of the society. This happens when the index of paying ability is translated in terms of equi-marginal sacrifice. In that case the society undergoes *least aggregate sacrifice* in meeting the tax liability.

Secondly, the ability to pay is not an absolute quantity. It is related, amongst other things, to the expenditure side of the government budget.

Thirdly, different indices are available for determining the relative ability-to-pay of the tax-payers. We can, for example, think of income, property and wealth, or consumption expenditure as some of the indices of ability.

Fourthly, it is sometimes thought that if we use income as the index of ability and have a combined objective of both equity and welfare

[1]E.R.A. Seligman, *Progressive Taxation in Theory and Practice*, 2nd edn., American Economic Association, Princeton University Press, Princeton, 1908.

then progressive[2] taxation necessarily follows. This is not so. Under certain conditions, proportional or even regressive taxation may follow from this combined objective.

As mentioned above, ability-to-pay is not an invariant quantity. Amongst other things, it depends upon the expenditure side of the government budget. A modern government is generally eager to adopt all feasible welfare policy steps. Various social security measures are adopted to help and protect the weaker sections of the society. Quite a few social services e.g., education are provided free or at subsidized rates. This certainly helps the weaker sections and changes the relative ability-to-pay of the members of the society. Some government expenses, even though not specifically designed to help particular sections of the society, may in practice be more helpful to some— that is to say the government expenditure is hardly likely to be distributionally neutral as between the society members. For example, irrigation projects with the objective of improving agricultural output of the country would be specifically helpful to farmers of particular areas. Basically, therefore, it is the overall budgetary policy which matters, and not just the taxation in isolation of the rest of the budget. However, for the sake of simplicity of analysis, we are limiting the argument to the taxation side of the budget only.

Although it is recognized that any fiscal policy will have repercussive effects, an analysis of such effects is ignored here. The government policies are bound to affect the savings, investment, production, employment and growth in the economy. These in turn will bring about shifts in the absolute and relative ability-to-pay of the citizens (by whatever criteria they be measured). For example, there is a general fear that progressive tax rates discourage saving and investment activity; and that if tax rates are progressive enough to bring about equality of income after tax, income-earning activity may not be pursued at all beyond certain limits. However, again in order to keep the argument at a simple level, this aspect of the problem is looked into later.

Cost-of-service approach to the distribution of tax burden implies that the government should try to have a balanced budget. The ability-to-pay approach does not have any such direct implication. Any

[2]In progressive taxation the tax liability increases both absolutely and as a proportion of income as income increases. In progressive taxation, though the absolute tax liability may increase with increasing income, as a proportion of income it will fall. In proportional taxation, tax liability stays as a given proportion of income irrespective of income level.

suggestion to this effect is further removed if we bring in the expenditure side of the budget to make the analysis more realistic. Actually, apart from other reasons, ability-to-pay approach has this advantage over other approaches that it admits of an extension of analysis into more realistic spheres and enables us to have a unified picture of the overall fiscal policy of the government. It can admit the interdependence of the government expenditure and the paying ability. It also follows from such an extension of the analysis, that the government should not decide its fiscal policy with any predetermined notions of necessarily having a surplus or a deficit budget. Depending upon the overall welfare and other considerations, the authorities can move ahead with a policy of a deficit or a surplus budget. Furthermore, such an approach of the overal effects of a fiscal policy also asserts that the authorities need not limit their revenue raising activities to taxation only—an active and effective debt management policy becomes a part and parcel of the government fiscal policy.

There can be difference of opinion as to what constitutes the ability to pay of the citizens. Here we can think of *an index (subjective or an objective one) of ability-to-pay*, on the basis of which the relative tax paying ability of different citizens would be determined. An *objective index* might be sought in wealth or property of the citizens, or in their consumption expenditure or in their incomes. *Subjectively*, the choice of *an appropriate index will be related to the sacrifice* that the tax-payers undergo in meeting their tax liabilities. Such a subjective index could be based upon only equity considerations or upon equity-cum-welfare considerations. That is to say, this index could be decided on the basis of what constitutes an "equal" burden of taxation; or upon apportionment of the sacrifice of tax-payers such as to impose the minimum aggregate sacrifice upon the tax-payers.

III (A) Objective Indices of Ability

(*a*) *Property as an Index of Ability-to-Pay.* The first objective index of ability-to pay would be the property or wealth of the tax-payers. By itself, however, it is not an adequate index. It is at the most an index supplementary to other indices. There are various limitations and conceptual difficulties in adopting this objective index. Assuming that the type of economy we are considering has the institutions of private property and inheritance (only then property as an index of tax paying ability would have any meaning), it follows that the tax system should be such as to allow the economy grow and develop in its own way. For the growth of an economy savings and investment process are essential and in the type of economy assumed by us, these

tasks are primarily in the hands of the private individuals (and families) and the corporate sector. Such a privilege of having the private property and inheritance acts as a great stimulant for the will to work, save and invest. If taxes are imposed with reference to property, such activities will obviously suffer, and will have adverse effects upon the growth and capital accumulation in the economy.

Furthermore, if tax rates are quite high, they would eat into the property, and such a set-back to saving and investment activity will be all the more. It must also be remembered that in an underdeveloped country, where the volume of such taxable property is likely to be low, and where inequalities of wealth are great, this revenue resource is very likely to be not only inflexible but also inadequate.

Property by itself is bound to be insufficient as index in many cases. Some properties yield more income than the others, and some may not be income-yielding at all. Similarly, considering the ownership of property to the exclusion of other sources of income will be highly misleading.

However, it is by no means implied that property and wealth should not be counted while estimating the ability-to-pay. Though some properties may not be earning income, yet by themselves they do indicate potential tax-paying capacity of the owners. Also from the point of view of welfare, it is not good to let concentration of economic power take place. Moreover, concentration of economic power generates the possibilities of economic exploitation, and leads to unequal economic opportunities for the citizens. It is for this reason that taxing of gifts and inheritances should find an important place in any egalitarian tax system. Besides, it is generally recognized that income from property confers, others things being equal, greater tax paying ability upon the owners[3] than the same income which has been earned otherwise. Capital gains and unearned increments are also there. Also in a market economy, the property owners, especially the wealthier ones, enjoy unequal economic opportunities or are also able to manipulate the working of the economy to their advantage.

In conclusion, we may say, that it will be erroneous to rely upon property as the sole index and source of taxation, but it is an important variable for both these purposes. Any good tax system will take into account the property ownership and the powers which it confers upon the owners and would consider it as an important source of public revenue.

(*b*) *Consumption Expenditure as the Index of Ability*. Another objec-

[3]E. H. Plank, *Public Finance*, Richard D. Irwin, 1953, p. 180.

tive index of ability-to-pay is the consumption expenditure of the members of the society. Though various arguments can be put forth in favour of consumption expenditure as an index of ability-to-pay, this is not likely to be a satisfactory index at all. It is a far difficult index to construct and a still more difficult tax to administer if the tax liability is to be determined on the basis of aggregate consumption expenditure of a citizen as during a given period of time. If some simple devices are adopted, like excise duties or sales taxes, it is implied that the citizens can be classified into ability categories according to the goods and services they consume. As it is, some of the indirect taxes can be quite regressive in their nature.

A further argument against the consumption expenditure would be the fact that in the economy, our wants and their satisfaction are not limited to consumption only. Every economy has to undertake saving and investment also. It is, therefore, quite questionable to tax only that part of income which is consumed, and leave out that portion which is saved and invested.

Furthermore, it is possible for propertied people to plough back their earnings into investment and increase the concentration of economic power in their hands without attracting tax liability. Use of a tax on consumption can be made as a part of the overall tax system, but not as the only form of public taxation.

(c) *Income as the Index of Ability-to-Pay.* Income is one of the most accepted indices of ability to pay, though it is usually supplemented by other tax indices also. Even Adam Smith, while asserting the ability criterion as the first canon of taxation, appears to maintain that such ability is in proportion to the respective incomes of the taxpayers. However, as we shall see, income itself, from the point of view of ability-to-pay, is subject to different interpretations. Accordingly, various conceptual points have to be clarified before this index can be recommended and of course, as in any other index, there are various practical difficulties also. However, as we shall see, of the various indices available, this is the most acceptable single index.

According to this approach, a citizen receiving a larger income is made to foot a larger tax bill and vice versa. As a matter of detail, income is divided into two parts. (*i*) earned income, and (*ii*) unearned income. The latter includes capital gains etc., and is subjected to heavier taxation. Also, it is net and not gross income which should be considered for this purpose. This is because expenses might have to be incurred to earn the income under consideration. Therefore, various deductions are permitted from taxable income. Expenses needed to earn income are not necessarily monetary expenses. Theo-

retically, it is the overall effort or disutility of work which should be considered as the cost of earning that income. An ideal index would, therefore, consider net income inclusive of leisure income. A person's net income should mean his gross income plus leisure minus 'expenses' incurred to earn that income. However, net income, even when measured in this rigorous way, is not an ideal final index of tax paying ability. The ability to pay will also have to consider both income and needs of the tax-payer.

Apart from the above mentioned qualifications, the ability is also a function of the marginal utility of income. This poses a tricky problem. It means that in order to estimate the relative ability to pay of different tax-payers, we must know, firstly, measure of income to be used as the index of ability and, secondly, the marginal utility of that income. This aspect of the problem brings in the subjective considerations in determining the tax liability and they are looked into later.

There are certain other limitations also when we use income as an index of ability-to-pay. The question is intimately connected with the form of taxation—do we use income tax, or excise duties or sales tax etc.? The income as an index of ability-to-pay appears far less relevant in the case of corporate incomes with which the ownership pattern of the corporate sector is not necessarily positively correlated. An individual or family might own a number of small enterprises and thereby acquire a large amount of income. Alternatively, a large business may be owned by a number of individuals or families, each getting a small amount of income.

In the same manner, it is difficult to use indirect taxes. Since indirect taxes are collected as taxes on commodities and services, it is implicitly assumed that the consumers can be classified into homogeneous groups of equal ability-to-pay according to the types and quantities of goods and services purchased. This is obviously a highly unrealistic assumption.

In the case of underdeveloped countries, it may be partially correct to assume that the richer sections will be interested in purchasing various items of luxury. But even there it is not necessarily so. In the countryside, even very rich farmers are not likely to have refrigerators or air-conditioners etc., simply because there may not be any electricity. In the advanced countries, the difficulty is still more because there the consumption pattern is still less indicative of the relative ability.

However, in spite of all the imperfections, income as an index of ability is more appealing than other indices. It still satisfies our *a priori* expectations to a great extent.

In practice, however, often it will be helpful if we adjust and determine the tax liability at multiple levels based upon income, consumption, wealth and property, gifts and inheritances, capital gains and unearned increments etc. *Also it will be helpful if the form of taxation includes both direct and indirect taxes in their variety.*

III (B) Subjective Indices of Ability-to-Pay

Subjective approach to the ability-to-pay proceeds on the assumption that a tax-payer undergoes a hardship or suffers a sacrifice by paying the tax. It is assumed that he does not feel better by the idea that he is contributing to the welfare of the society through helping the State in its multifarious activities. Also, it is assumed that a tax-payer's sacrifice depends upon his own tax liability, and is not affected by the tax liability of others.

Assuming that tax paying means a sacrifice on the part of the tax-payer, we can discuss the question of determining the tax liability of each tax-payer either in terms of equity or in terms of welfare. Equity approach will dictate that each tax-payer should be made to undergo 'same' amount of sacrifice irrespective of his income etc. Welfare approach will dictate that the aggregate sacrifice of all the tax-payers should be the minimum, so that the resultant welfare loss to the community is the minimum. It shall be seen that 'equal sacrifice' admits of different interpretations and one such interpretation tallies with the welfare considerations also.

As stated above, the equity approach maintains that each tax-payer should be subjected to the 'same' or 'equal' sacrifice. This term admits of three interpretations, viz. *equal absolute sacrifice*, *equal proportional sacrifice* and *equal marginal sacrifice*. Dalton adds a fourth possible interpretation, namely, constant inequality of incomes.[4] It means that the inequalities of incomes as between different tax-payers should remain the same after the tax as they were before the tax. Equal marginal sacrifice also leads to the *Least Aggregate* or *Minimum Aggregate Sacrifice*. Now the problem is to choose the right type of meaning of 'equity.' As Dalton says, "*Prima facie*, it is not clear, on grounds of equity, which of these four is to be preferred."[5] While applying any of these principles, or interpretations, we have to know the utility function of income. That is to say, we must know the way in which marginal utility of income varies as income of a

[4] H. Dalton, *Public Finance*, London, Routledge and Kegan Paul Ltd., 1949, p. 91.

[5] *Ibid.*, p. 91.

tax-payer changes. This is a highly tricky area.

Utility is a subjective entity and cannot be measured in absolute terms. It is still more difficult to have an inter-personal comparison of utility, especially when marginal utility of income itself might be changing due to time, tastes and needs etc.[6] At the same time, it must be remembered that without the assumptions of cardinal measurement and inter-personal comparison of utility, it is not possible to have any precise conclusions regarding the division of tax burden between tax-payers in terms of their respective ability to pay. But it is generally admitted that commonsense demands that the assumption of similarity in utility schedules is more plausible than any other assumption and that the same may also be assumed income distribution. The assumption of similarity of income-utility schedules has been made even by those authors who do not accept its scientific validity. For example, Dalton says, "most of us, at given levels of income, are more alike each other in our normal needs and moods, and our reactions to variations in our income, than some theorists recognize."[7] Even Lionel Robbins who is considered a champion of positivism, says, "I do not believe and I have never believed that in fact men are necessarily equal or should always be judged as such. But I do believe that in most cases, political calculations which do not treat them as if they were equal are merely revolting."[8]

Similarly, Lerner asserts that if currently different individuals have different capacities to enjoy income, it still points towards the need to bring about income equality, but slowly, so that over time the lower income people may also acquire a capacity to enjoy larger incomes.[9] However, agreeing that it is not possible to have objective measures of utility, we may offer the following observations.

(*a*) *Equal Absolute Sacrifice.* This means that different tax-payers

[6]"It remains to be seen whether a workable and reasonably meaningful measure of utility can be developed in time and whether thereby the subjective concept of ability-to-pay can be given an operational meaning At this state, we do not possess a universally accepted measure of utility by which to apply one or the other sacrifice formula." R.A. Musgrave, *The Theory of Public Finance*, McGraw-Hill, 1959, p. 109.

[7]H. Dalton, *op. cit.*, p. 92, footnote 2.

[8]Lionel Robbins, "Interpersonal Comparisons of Utility," *Economic Journal*, Vol 48, No. 4, December 1938, pp. 635-41, quoted in R.A. Musgrave, *op. cit.*, p. 109.

[9]A.P. Lerner, *Economics of Control*, The Macmillan Co., New York, 1944.

are made to sacrifice the same amount of utility by way of taxes. To put it differently, the difference between the aggregate utility from income before tax and the utility of income after tax is the same for every tax-payer. Symbolically, $U(Y)-U(Y-T)$ should be the same for all, where U is the total utility, Y the income before tax, and $Y-T$ the income after tax. If this doctrine is applied, each member of the society will be paying some tax at least and none will be exempted contributing a share to the public revenue. But we still have to investigate whether tax rates should be regressive, proportional or progressive.

Let us assume that the income-marginal utility schedules are identical for all, that is, each individual has the same capacity to enjoy income. If now we further assume that the marginal utility of income is constant (marginal utility curve runs paralled to X-axis) then it follows that each tax-payer should pay the *same absolute amount* of income as tax. This will mean a lower *rate* of tax as income increases, that is, regressive rates. On the other hand, if the income utility schedules fall, that is, if marginal utility of income falls as income rises, then with rising income, tax amount will have to increase to represent the same amount of sacrifice. When the rate of fall in marginal utility of income equals the rate of rise in income, proportional taxation will result in equal absolute sacrifice. On the other hand, if the marginal utility of income falls at a rate faster than the increase in income, then the equal absolute sacrifice will require progressive tax rates. It, should be noted, however, that unless the slope of the marginal utility curve is known precisely ever the relevant range, the above conclusions cannot be drawn.

(b) Equal Proportional Sacrifice. According to this principle also, no one is exempt from sharing the tax burden. In this case, each taxpayer is supposed to sacrifice the same percentage of the total satisfaction which he would have derived from his income. It means that the satisfaction lost in terms of tax payment bears the same proportion to the satisfaction from the pre-tax income in each case. Symbolically, it would mean that the tax liability of each individual is determined in a manner that for his income Y, $[U(Y)-U(Y-T)] / U(Y)$ is a constant. However, while in the case of equal absolute sacrifice, we were able to lay down the rules for progressive, proportional or regressive tax rates (with reference to the rate at which marginal utility falls with an increase in income), such an easy generalization is not possible in this case. Here the relative rate of change in marginal and average utility of income will have to be looked into. If the marginal utility of income remains unchanged, then equal proportional sacrifice would call for a proportional taxation. On the other hand, if the

marginal income utility falls, then we shall have to look at the relative percentage shifts in the marginal and average utilities. If the decline in marginal utility is of the same rate as the decline in the average utility then proportional tax will satisfy this objective. If the fall in the marginal utility is at a rate faster than the fall in the average utility, progressive taxation will be called for. If the fall in the marginal utility is at a rate smaller than the fall in average utility, then regressive taxation will be needed to satisfy this criterion.

The above analysis can be presented graphically also. In Fig. 6.1, income is measured along horizontal axis and marginal utility of income along vertical axis. If marginal utility falls at the same rate as the rate of rise in income, then the marginal utility curve would be drawn such that for each point the rectangle formed by the abscissa, the ordinate and the two axes bears the same proportion to the area under the curve to the left of this point. The equation of this curve is given by $U'(Y_1)/U'(Y_2) = \sqrt{Y_2/Y_1}$ where $U'(Y_1)$ and $U'(Y_2)$ are the marginal utilities of incomes Y_1 and Y_2. Let us draw a straight line passing through the origin O, intersecting the line of proportions at P and forming an angle of 45° with each axis. Also let a rectangular hyperbola APB pass through point P. Then the line of proportions CPD would lie below the rectangular hyperbola to the left of P and above it to the right of P. Now, for equal proportional sacrifice we have the following conclusions. If the marginal utility curve coincides with CPD, the income tax rates should be proportional; if it falls more rapidly than CPD, then the rates should be progressive; they should be regressive if the marginal utility curve descends less rapidly than CPD. Thus we find that in the

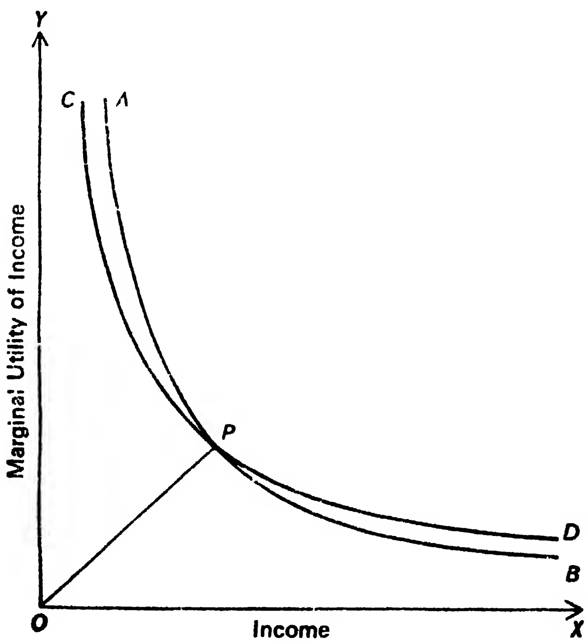


FIG. 6.1.

case of equal proportional sacrifice, the tax rates do not have to be progressive simply because income is subject to falling marginal utility. It should be noted, however, that the above conclusions are based on the assumption that the behaviour of the marginal utility of income (that is, the slope of the marginal utility curve) is known over the entire range of income.

(*c*) *Equal Marginal Sacrifice or the Least Aggregate Sacrifice.* According to this interpretation of equity, the tax burden should be apportioned in such a way that the marginal utility of income left after tax with any tax-payer would be the same. Symbolically, for each tax payer, $U'(Y-T)$ should be the same. In this principle the emphasis is equally on the welfare of the community. It follows from the utilitarian dictum of "the greatest happiness of the greatest number." This philosophy asserts, amongst other things, that the aggregate sacrifice imposed on the community by the taxation should be the least possible. However, though this doctrine sets the objective of least aggregate sacrifice by the tax-payers, "there is no generally accepted view as to what it involves in terms of individual sacrifice."[10] Musgrave, Pigou and others consider it the "ultimate principle of taxation."[11]

In this case, if we assume that the marginal utility schedules are identical and sloping downwards, then it follows that the taxation would begin with the highest income and once that income is topped off to the next highest income, both incomes start sharing the taxation equally, and so on. In the end, either all incomes left after taxation are equal or (in the case of tax revenue being not so much) all the taxed incomes are equal while the non-taxed incomes are smaller than the taxed ones. "It has been suggested that this principle would be realized by taxing only the largest incomes, cutting down all above a certain level to that level, while exempting all below that level. Thus, all incomes above, say, £1500 a year would be reduced by taxation to the figure, and on one, whose income was less than this, would be taxed at all."[12]

It is also clear that with these assumptions, this principle necessarily leads to progressive taxation—a conclusion which is sometimes erroneously supposed to be applicable to other cases also.

[10]E.H. Plank, *Public Finance*, Richard D. Irwin, 1953, p. 177.

[11]R.A. Musgrave, *op. cit.*, Ch. 5, c., c and A.C. Pigou, *A Study in Public Finance*, 3rd edn., Macmillan and Co., 1951, Part II, Chapter I.

[12]H. Dalton, *Public Finance*, pp. 86-87. For a similar statement, also see A. C. Pigou, *A Study in Public Finance*, 3rd edn., Macmillan and Co. 1951, p. 57.

It is well known that utility cannot be measured and interpersonal comparisons of utility are not possible. On this basis, some writers insist that the above conclusions are not scientifically based. In the absence of any relevant information, it is not possible to prove that the best way of apportioning tax burden would be to enforce equal incomes after tax. However, Lerner[13] shows that even when the marginal utility schedules are not precisely known, and even when we do not have the possibility of interpersonal comparisons of utility, still it is possible to conclude that a shift towards equality in income distribution would maximize the aggregate satisfaction of the community. However, he bases the argument on the assumption that in the absence of definite information, the ***probability*** of a loss in aggregate satisfaction may be taken as high as that of a gain in aggregate satisfaction when income is redistributed. However, in his analytical framework, the ***amount*** of a probable loss is more than the probable gain if there is a move from equality towards inequality (and therefore, the amount of probable gain exceeds the amount of probable loss if we move from inequality towards equality). As a result, the society maximizes its probable aggregate satisfaction when incomes are distributed equally. Lerner's conclusion, however, rests on ***probability argument*** only and cannot be taken to be ***objectively conclusive.***

Pigou says that the right goal of every government is the maximum welfare of the community. And "in the special field of taxation, this general principle is identical with the principle of least sacrifice."[14]

A NOTE ON TAXABLE CAPACITY

The concept of taxable capacity is intimately connected with the concept of ability to pay, though the two concepts are not equivalent to each other. The ability-to-pay refers to a method of apportioning a given tax burden amongst the tax-payers. Such a share of a tax-payer according to this apportioning method may or may not exceed his capacity to pay. Also the ability-to-pay refers only to the existing set of circumstances and repercussive changes are not brought into account. Taxable capacity on the other hand refers to the maximum tax which might be collected from a particular tax-payer or a group of tax-payers under consideration. Such a tax paying capacity may be estimated with reference to the economy as a whole, a region, an

[13] A.P. Lerner, ***Economics of control***, The Macmillan Co., New York, 1944, p. 30.
[14] A.C. Pigou, ***op. cit.***, p. 43.

industry, a group of individual, a particular country and so on. Such a measure of taxable capacity will be referred to as the absolute taxable capacity.

In relative taxable capacity, however, we compare the absolute taxable capacities of different tax-payers, or groups of tax-payers etc., (or even those of two or more countries). It is obvious that when a given amount of tax is to be collected such that the amount of tax to be collected is less than the aggregate absolute taxable capacity of all the tax-payers, the tax burden should be apportioned amongst them according to their relative taxable capacity. Since a tax-payer who has greater ability to pay will have correspondingly greater taxable capacity, it follows that the apportioning of tax burden according to either approach will yield the same result. While discussing the ability-to-pay concept, we have seen various conceptual and practical problems that are encountered in estimating the taxable capacity also. And these problems are magnified when we attempt to estimate absolute taxable capacities. In this section, we shall concentrate upon particular difficulties in defining and estimating absolute taxable capacity since the difficulties of estimating relative taxable capacity are similar to those encountered in estimating ability to pay indices.

We may start with an observation made by Dalton viz., " 'Taxable capacity, is a common phrase, but a dim and confused conception."[15] Here we should remember that the implicit reference is to absolute taxable capacity. Furthermore, Dalton talks of only absolute or relative taxable capacities of the whole communities and not of individual members within a community. Within a community, as we have seen, relative taxable capacity will be equivalent to an index of relative ability-to-pay.

Absolute taxable capacity refers to "the maximum tax" which can be collected from the tax-payers. Assuming that the State has an absolute authority over the resources of the community, the limit to taxable capacity would be the total resources of the community as a whole. Such an extreme measure, however, is not applicable for an individual tax-payer to the exclusion of others. It is because a modern State is expected to levy taxation without discriminating against any individual tax-payer. He can, therefore be taxed to the full amount of his resources if everyone else is treated in the same way. Anyway, in practical terms such an extreme measure of taxable capacity viz., the resources of the community, has no useful meaning especially

[15]H. Dalton *op. cit.*, p. 163.

where the means of production are not all owned by the State and where all the production decisions are not taken by the government. Any practical meaning of absolute taxable capacity will determine the limit to a figure much below this totality of the society's resources. Here then we have another extreme. It is sometimes stated that taxable capacity is that tax amount which can be collected without any suffering on the part of the tax-payers. This position is as objectionable as the earlier one since in that case the taxable capacity will be zero.

This, therefore, brings us to the additional variables which have to be encountered for estimating the taxable capacity. In the short run, it has to be decided as to how much sacrifice may possibly be imposed upon the tax-payers. In this connection people have referred to various basic figures like subsistence or existing standard of living etc. Incomes over and above these levels are supposed to represent the taxable capacity. It is obvious that all such measures are subjective and vague and cannot give any estimate of the taxable capacity.

The taxable capacity, in whatever way defined, is not a constant entity. In the long run, it is bound to change through saving, investment, economic growth, production pattern and so on. People have tried to relate the measure of absolute taxable capacity to these variables but without success—since the resultant effects on these variables cannot be so quantified as to assert that if a particular variable changes by a certain quantitative magnitude, the absolute taxable capacity of the community changes by so much amount, and so on. And the problem becomes totally insoluble when not a change in but an *absolute measure* of the taxable capacity is sought. In the latter case, vague statements will have to be made like the one saying that taxable capacity is reached when the production of the community is 'unduly' affected and so on. Such qualitative assertions have no meaning because they cannot be quantified easily and arguments cannot be put forth in favour of one in preference to the other.

If therefore, we are asked as to what is the absolute measure of taxable capacity of an individual or a community, we have no answer. Edwin Cannan's 'Nohow' is the ultimate answer. If, on the other hand, we are asked as to the factors which determine or affect such an absolute taxable capacity, we can mention them but only in a general way without being able to specify the quantitative effect of any. We can, however, talk of these determining variables in the context of short-run and long-run respectively.

Short-run Factors

If we assume that taxable capacity is the maximum tax which can

be levied without regard to the effects of or suffering therefrom, then it is equal to the absolute resources of the community owned by the members of the society. On the other hand, if taxable capacity is the tax which can be levied without any sacrifice on the part of the tax-payers, then the figure will be zero. In between these two extremes, a host of determining variables will have to be taken into account. Income and wealth distribution of the community will have an important bearing upon the capacity, since it will affect the marginal utility of income and wealth and hence the sacrifice which the tax-payers will have to bear. The pattern and rate structure of taxation, and the mode of tax collection will also be important variables. Indirect taxes are supposed to be psychologically less burdensome. Taxes on unearned increments, windfalls and capital gains are not expected to worsen the tax-payer's position as compared to the one in the base period. The timings and methods of paying some taxes can be more irksome than those of the others, and so on. In the same way, political and other factors will have their own bearing upon the willingness of the tax-payers to pay taxes. The citizens are willing to undergo more sacrifices during war which they believe to be a just one. Citizens who are more fervent in their religious and social obligations are ready to bear more taxes for financing such activities. Again, a lot depends upon the way the government is using the public revenue and the opinions of the tax-payers regarding the rationality of public expenditure.

Long-run Factors

Similar variables operate in the long run also. If the public authorities are helping the economy through capital accumulation, provision of social overheads, improving the productive efficiency of labour, encouraging the adoption of better techniques of production and so on, then taxable capacity will improve—in whatever way it is being defined. Monetary and fiscal policies of the government which bring about economic stabilization with a high level of employment and production will naturally enable the community to pay more taxes than if it was passing through a phase of depression and unemployment. Government policies in the field of foreign trade and capital movements also can have a profound effect on the cost price structure and the productive capacity of the country.

However, the concept of relative taxable capacity, we may assert, is a more practical concept; and it has often to be used also in one form or the other. A measure of relative taxable capacity may be needed as between the two countries or between different tax-payers of the

same country. The need for the former would arise in apportioning the cost of various international organizations, or when poorer countries are to be helped in their economic growth or in natural calamities etc. Here a useful and plausible criterion would be a composite index of per capita income and national income of each country under consideration. Regarding the relative taxable capacity as between different tax-payers in the same country, an acceptable index of relative ability to pay has to be formulated.

In the case of relative ability to pay, as we have seen earlier, no final criterion is available for constructing the index of ability to pay. Of the ones available, income is the most acceptable criterion though this ought to be supplemented with property and expenditure criteria. The income criterion itself has to be used with caution and the index of relative ability to be estimated by covering quite a few conceptual and practical considerations. As stated above, a proper definition of taxable income will have to take into account the marginal utility of income, the leisure income, effort and expenses incurred in earning that income, the nature and source of the income and so on. The pattern of government expenditure is also an important variable here. And so are the composition and mode of tax collection. Furthermore, the employment policy and overall income and wealth inequalities are important variables in estimating the relative taxable capacity. It is also clear that any measure of relative taxable capacity will be subject to variations over time on account of the factors affecting it. Before the popularity of econometric methods, it was found extremely difficult to assess changes in the relative taxable capacity as between regions, sectors or economies. For this purpose, some important economic variables are chosen and regression analysis is used to quantify the extent of variation in the relative taxable capacity in quantitative terms.

In conclusion, we may say that, "Relative taxable capacity . . . may be given an intelligible meaning. Principles. . .may be laid down to govern the distribution of a given burden between two or more persons according to some criterion of 'ability-to-pay'."[16] But the concept of absolute taxable capacity "should be banished from all serious discussions of public finance."[17]

Usefulness of the Concept

We may legitimately ask as to whether the concept of taxable

[16] *Ibid.*, pp. 169-170.
[17] *Ibid.*, p. 171.

capacity has any relevance in theory or in practice. From the above discussion it is clear that the concept tends to overlook the fact that the state sector forms an integral part of the economy. For a proper appreciation of this problem we must explicitly recognise that the basic problem before the state is not to assess what the private sector should pay to the state sector by way of taxes. Its primary concern, on the other hand, should be with the totality of its budget in which tax revenue would form but only one component. The state, equipped with adequate knowledge of the responsiveness of the private sector to various fiscal measures, should formulate an optimal budget—a budget that yields maximum welfare for the society under given circumstances. Such an optimal budget lays down a simultaneous determination of the level and composition of public expenditure, level of tax revenue, rates and coverage of the tax system,and public debt policies including the borrowings from the banking system and the central bank of the country. The optimal budget takes care of the effects of its operations and policies on employment, price stability, balance of payments position, generation of income and output, income and wealth distribution and so on The concept of taxable capacity, on the other hand, tries to set a limit to the size of the budget while it refuses to recognise that the state sector (and hence the level of public budget) has a lower limit for a workable efficiency of the economic system as a whole. Musgrave, therefore, advocates that "the concept of taxable capacity must be discarded in favour of a concept of optimal budget."[18] However, we must concede that given a decision to collect a certain amount by way of tax revenue, the concept of relative taxable capacity has still a meaning from the standpoint of equity of division of tax burden which we have considered in this and the preceding chapters.

[18]R. A. Musgrave, *op. cit.*, p. 51.

7 INCIDENCE OF TAXES

It is a patent fact that the economic unit upon which the authorities impose a tax may not be the ultimate payer of that tax. Each economic unit is related to the others through various economic transactions and it may be possible for the economic unit which is statutorily liable to pay the tax to collect a part or whole of the tax from others. In this chapter, we shall analyze the possibility and phenomenon of shifting the money burden of the tax by those who have the statutory responsibility of paying it in the first instance.

The Impact, the Incidence and the Effects of the Tax[1]

Impact of a tax is the *first point of contact* of the tax with the taxpayers. It is upon those who bear the first responsibility of paying it to the authorities, that is those who have the statutory responsibility of paying it to the government. *Incidence* of a tax, on the other hand, is defined as its *final resting place*. It is to be seen and judged in terms of the money burden of the tax. To put it differently, the incidence of a tax is upon those economic units which finally bear the money burden of it and which are not able to pass it on to others. Incidence lies upon that final source from which the tax money comes.

Any particular tax (such as an excise duty) is likely to be borne by a large number of economic units which may or may not be divisible into homogeneous categories. Even a single unit of a tax, such as the excise duty collected on one unit of an item of production, may be shifted and finally shared by a number of economic units. It is also likely that the task of tax shifting passes through several stages and the final incidence of a tax gets well scattered. The money burden of a tax can be shifted, partially or fully, only through the vehicle of price variations. Price may be raised in the sales transactions or may be lowered in purchase transactions. As a result, in the process of tax shifting, prices of various goods and services change. If however, the sales transactions of a taxed good or service come to an end, there is no possibility of shifting the incidence at all. And if the tax happens to be on a commodity, service or an item which ceases to exist, then there would be no incidence of the tax upon anyone because the tax would not be collected in this case and for the pur-

pose of incidence it just would not exist.

When a tax is imposed and collected, it involves certain responses from the tax-payers and the economy. Such responses can be of great variety and can profoundly influence the working of the economy in terms of production, growth, saving, investment, choice of techniques of production, regional imbalances, inequalities of income and wealth, and so on. These responses and their results are collectively called the *effects of that tax*. The effects of a tax, therefore, stand apart, both conceptually and analytically, from both the impact and the incidence of the tax. While the impact of a tax is its first point of contact with the tax-payers and while incidence is its final resting place, its effects will be the resultant responses and changes in the economy. These effects can be the result of the fact of tax imposition itself and they could also follow from the process of shifting its incidence. For example, the minimum effects of a tax, when it is imposed, will be a reduction in the disposable income of the tax-payers; and if the tax is shifted, then at least some prices would change.

Effects of a tax can be both beneficial and harmful. Harmful effects of a tax will be referred to as the burden of that tax. Such a burden will have two dimensions—*money burden* and the *real burden.* Money burden refers to the reduction in the disposable income of the tax-payers. Money burden of a tax, moreover, may be direct or indirect. *Direct money burden* refers to the amount of tax being paid by the tax-payers to the authorities. It is, therefore, equal to the tax collections. But as we know, the fact that a tax is being imposed and collected can cause additional expenses to the tax-payers. A tax-payer, for example, might have to go to the Treasury to deposit the tax amount and thereby incur some expense on conveyance. Such additional money expenses would be called *indirect money burden* of the tax.

The harmful *effects* of a tax, such as in terms of increasing unemployment, or reduced production etc. will be called its *real burden.* It is equal to the loss of welfare to the tax-payers and the community as a whole. A real burden itself may be divided into two parts, namely, *the direct* and *the indirect real burden*. Direct real burden of a tax will be the sacrifice of the welfare which a tax itself imposes upon the tax-payers. It, however, is not net of the benefits, if any, of the tax. Since a tax can also generate various harmful effects indirectly, such an indirect loss of welfare will be referred to as the indirect real burden of the tax. This indirect real burden is also not net of the possible benefits of the tax.

Mrs Hicks uses the terms *formal* and *effective incidence* of a tax.[1] To her, formal incidence of a tax means the money burden of a tax or its money incidence. In her own words, formal incidence refers to "the proportion of people's incomes which goes not to provide the incomes of those who furnish them with goods and services, but is paid over to governing bodies to finance collective satisfaction."[2] Here she is referring to the activities of the authorities for providing various public services to the community for which they need finance. Such a financing may be provided not directly by the tax-payers but through purchases and sales. Mrs Hicks, therefore, is implicitly assuming that there is always a difference between the impact and incidence of a tax. We may say that a special case of Mrs Hicks' proposition would be one where the impact and incidence of a tax rest upon the same place.

Further, it would be noted that the formal incidence of a tax is equal to the amount of that tax collected by the Treasury and the formal incidence of the tax system as a whole is equal to the total tax revenue of the authorities. For the tax system as a whole, it will mean the final resources which are transferred to the authorities by way of a tax system. Effective incidence, on the other hand, is equivalent so the effects of taxation in the usual sense of the term. It will include all the advantages and disadvantages which an economy derives from a tax system. It is nearly impossible to properly estimate the effects or effective incidence of a tax. If the tax is already there, we have to compare the situation as it is with the tax with the one which would have been there without the tax. The latter possibility is, however, a hypothetical one. Similarly, if the tax is not there we have only the situation without the tax. This situation is to be compared with the one which would obtain if the tax in question is imposed. Since in either case, one of the situations to be compared is hypothetical, such a comparison is nearly impossible.

Musgrave uses the term incidence of a tax in a different sense.[3] When a tax is imposed, or its rates etc., are changed, the effects are felt in different spheres of the economy. The 'incidence' of a tax is "the resulting change in the distribution of income available for private uses."[4] The distributional effects of changes in a particular

[1]U.K. Hicks, *Public Finance*, Pitman Publishing Corporation, New York, 1947.

[2]*Ibid.*, p. 158.

[3]R. A. Musgrave, *The Theory of Public Finance*, McGraw-Hill Book Co., 1959.

[4]*Ibid.*, p. 211.

tax are called *specific tax incidence.* On the other hand, assuming that the government is interested in choosing between alternative ways of raising a given amount of real resources by means of taxation, the "distributional changes that result as one such tax is substituted for another are referred to as the differential tax incidence."[5]

Forward and Backward Shifting

Now a tax may be shifted either through a sales transaction or through a purchase transaction. For example, if a producer is asked to pay an excise duty on his product, he may enhance the sale price of the product or he may force the suppliers of raw materials or other inputs to him to accept lower prices. In the former case, it is forward shifting. The producer is collecting a portion of the tax from his customers and is shifting a portion of the tax burden forward. Since a tax is shifted through the means of a price variation, in the case of forward shifting, the price of the commodity or service through which the tax is being shifted, will increase. On the other hand, it becomes a case of backward shifting, if the tax is shifted through the vehicle of purchase transaction. In our example, backward shifting will occur if the producer reduces the purchase price(s) of an input (inputs). It must be emphasized that along with an imposition of a tax, there is likely to be a change in the demand and supply forces of the taxed good implying that the price of a good also undergoes a change additional to the one brought about by the sheer fact of tax shifting. It is obvious that only that change in price would be indicative of a shift in the incidence of a tax which takes place on account of that tax and not on account of the shift in demand and supply forces. In a modern economy, demand and supply forces are generally subject to a dynamic change and accordingly, it becomes quite difficult to estimate the price that would have been there in the absence of the tax. Furthermore, it is not necessary that a tax must be shifted only forward *or* backward. It can shift partly in each direction, depending upon the sales/purchase transactions involved and the market forces at work. Also, it would be readily seen that the shifting of incidence of a tax need not be of a given pattern only. Over time, with changing demand and supply forces, the incidence may shift differently.

Shifting of a Tax through Tax Capitalization

There are certain durable items like houses, cars etc. which are

[5] *Ibid.*, p. 212.

subject to periodic taxes. If in this case, the tax is to be shifted backwards, then it is essential that the purchaser shifts it back at the time of its initial purchase which means that the purchase price is to be reduced sufficiently so as to cover the amount of the tax to be paid periodically in future. In this case an equivalent of the future tax payments is found in terms of the present value and the purchase price of the item is reduced by a part or full amount of that value. Such a reduction of the purchase price by the purchaser is called *tax capitalization*. The principle of tax capitalization can be understood by looking at the way the buyer would work out the offer-price for a durable item.

Let $R_1, R_2, R_3, \ldots, R_n$ be the money receipts (or money equivalents of the services) which the taxed item is expected to yield to its owner at times $1, 2, 3, \ldots, n$ in the future. Let $T_1, T_2, T_3, \ldots, T_n$ be the amounts of taxes to be paid out of the receipts $R_1, R_2, R_3, \ldots R_n$, Let $r_1, r_2, r_3, \ldots r_n$, be the rates of interest for period $1, 2, 3, \ldots, n$, respectively. Then the present worth of the net receipts from the taxed item under consideration is given by

$$PW=\frac{R_1-T_1}{(1+r_1)}+\frac{R_2-T_2}{(1+r_2)^2}+\ldots+\frac{R_n-T_n}{(1+r_n)^n}=\sum_{i=1}^{n}\frac{R_i-T_i}{(1+r_i)^i}$$

The price offered by the purchaser is limited by PW. It obviously falls (rises) as the tax amount rises (falls).

Theories of Tax Shifting

There are quite a few theories and ideas as to who pays the tax in the final analysis, that is to say on whom the final incidence of a tax rests. In this connection, there are three prominent approaches which we shall consider one by one. They may be referred to as the Concentration Theory, the Diffusion Theory and the Demand and Supply Theory.

A. The Concentration Theory. This approach maintains that there is an inherent tendency for the taxes to be absorbed by certain income classes. It was advocated by the Physiocrats and the Classical economists. The Physiocrats believed that in an economy only those could bear the taxes who were appropriating a "surplus". To them the artisans and other classes (except peasants) were not producers of surplus since in such cases the value of the final output was only equal to the value of the inputs. However, the story was a different one with agriculture. There the produce far exceeded the

inputs and it was this surplus which was appropriated by the landlords as rent. The peasants were left with only that much of income which was necessary to maintain themselves and perpetuate their labour supply. In the same manner the artisans also got only that much of income which just represented their reproduction cost. Accordingly, the only source from which tax revenue could finally come was the land rent. If a tax was imposed on any other sector of the economy, it would get shifted to agricultural rent through interdependence of the economic sectors and the agricultural rent would finally absorb it—incidence of any tax would rest there. It was therefore better if taxation was levied on agricultural rent in the first place itself.

The Classical economists were able to add a refinement to this analysis. They realized that there were two surpluses in the economy, namely, rent and profit. Accordingly, all tax incidence would get concentrated on these two surpluses and would be absorbed by these. Let us consider some possible taxes to see how this is corroborated.

Land rent, according to Ricardian theory, arises due to the fact that agricultural production is subject to the law of diminishing returns and that with increasing population and demand, the supply of agricultural output and hence the marginal cost of production increases. The Classical economists also believed in the subsistence theory of wages and the Malthusian theory of population. Accordingly, in the market the wage rates of the workers and the peasants would tend to settle at subsistence level. If they ever slumped below this level, the result would be a reduction in labour supply because labour would start dying off. On the other hand an increase in the wages over subsistence would increase the labour supply in the long run. In the short run, however, labour supply can be taken as fixed so long as wages do not fall below subsistence.[6]

Now suppose a tax is levied on agricultural produce. It means that with the additional cost of cultivation same output is being collected. This would raise the marginal cost of cultivation also. Because due to given population in the short run, the demand for agricultural goods does not fall, therefore agricultural prices go up. This raises the cost of subsistence of the workers. Wages would have to increase and they would cut into profits. Rent income does not fall because

[6]Of course, there was no definite agreement as to what constituted 'subsistence'. Even Ricardo himself maintained that subsistence was a variable quantity subject to changes over time and due to customs etc., See David Ricardo, *On the Principles of Political Economy and Taxation*, p. 222.

the landlords pay the tax on agricultural produce out of higher sales proceeds collected by them through higher agricultural prices. Thus, the incidence of the tax finally rests upon the profits. However, if a tax is imposed not on agricultural produce but on agricultural rent itself, the landlords will have no vehicle to push the tax incidence on to others because rent does not form a part of the cost of production, marginal cost of cultivation remains unchanged and so does the rent income.

If a tax is imposed upon wages, the workers will have to be compensated through additional money wages to give them a given real subsistence.[7] Those who are appropriating profits will not be able to shift the tax incidence; but landlords will be able to. Higher wages would increase the marginal cost of cultivation and so via higher agricultural prices the tax incidence will be shifted to profits. If however, a tax is levied on profit income itself, no shifting takes place and the tax is absorbed right there because wages, which are already at subsistence level, cannot be pushed down further.

B The Diffusion Theory. If we believe in the interdependence of various economic units in the economy and if we believe that the wage rates are not settling at subsistence level so that the "surpluses" exist throughout (we may even claim that at least in the short run, there is an element of rent or surplus in the earnings of every factor), then it follows that a tax imposed at one place could shift to far flung sectors of the economy. Because of the constant interaction of sales purchase transactions, some people have maintained that eventually it becomes impossible to trace the final incidence of any tax and that in reality all taxes get "diffused" in the economic system. Dalton, however, does not agree with this thinking.[8] He asserts that such an approach only tries to run away from the basic problem of ascertaining the incidence and the effects of a tax on account of the great difficulties which such an attempt encounters. In the case of some taxes, of course, the effects are widely diffused but with a proper analytical approach it should be possible to estimate both the incidence and the "wider effects" of the tax. The assertion that the taxes get 'diffused' in the economy is obviously based upon the implicit assumption that the market is sufficiently competitive and that the

[7]Adam Smith says that money wages must rise if the money cost of subsistence rises due to a taxation of necessities Of course money wages must rise if wages themselves are taxed See Adam Smith, *Wealth of Nations*, The Modern Library Edition, 1937, p. 822.

[8]H. Dalton, *Public Finance*, 1949, p. 71.

factors of production can move from one employment to the other quickly, easily and without appreciable cost. It will follow that in that case it hardly matters where the taxes are imposed in the first place since they shall anyhow get well diffused in due course of time. However, this theory is obviously based upon a wrong judgement of facts.

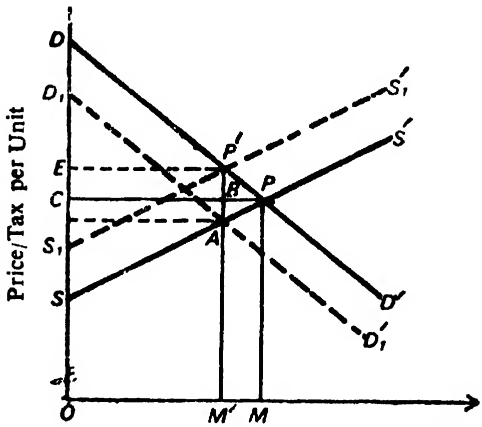
Firstly, we know that even if the implicit assumptions of this theory were correct, it would not have been a matter of indifference as to where the taxes are imposed. As Musgrave points out, why should we demarcate between the incidence (in the conventional sense of the term) and the resultant 'effects' of taxation? Incidence of a tax may be very important but so would be the 'effects' of it and the authorities should not be indifferent as between these different effects.

Secondly, the assumptions upon which this theory is based are patently unrealistic. We know that in practice, markets are seldom adequately competitive, for monopolistic competition and other types of imperfections are the order of the day. Factor mobilities are restricted due to more than one reason. It is, therefore, hardly justifiable to expect that the tax incidence will get 'diffused' in the economy. In a number of cases, it may tend to sit where it is imposed. As we are arguing at other places in this Chapter, shifting of a tax and its division between different tax-payers depends upon the elasticities of demand and supply and the sales transactions which are taking place.

C. Demand and Supply Theory. This is the most acceptable approach in explaining the incidence of a tax. Tax incidence can be shifted only through sale/purchase transactions and only through a revision of the prices. A price revision is possible and is determined by the relative values of demand and supply elasticities. A tax can, therefore, be shifted only through a shift in the demand and/or supply curves and the sharing of the incidence will be determined by the demand and supply elasticities. The general rule is that irrespectives of whether the statutory liability of a tax (the impact of the tax) rests upon the buyer or the seller, the share of the tax borne by the seller will be the larger according as the elasticity of demand is larger; and the share of the tax borne by the buyer will be the larger according as the elasticity of supply is larger. Actually, the tax burden will be shared between the buyer and the seller in the ratio of the elasticities of supply and demand.

Let us illustrate this statement by first taking the case of a single commodity which has been subjected to a specific (per unit) tax. Let us assume that the impact of the tax is upon the sellers. Let (refer to

Fig. 7.1) the original demand and supply curves for the commodity be DD' and SS'. With the imposition of a tax SS_1 per unit upon the commodity, the supply curve shifts to S_1S_1' and the price of the commodity rises from PM to $P'M'$. However, out of this $P'M'$, the sellers get only AM', the balance being collected by the government by way of tax. In other words, the incidence upon the sellers is equal to BA per unit. On the other hand, the buyers are paying now $P'M'$ instead of PM, an increase of $P'B$ per unit which is the incidence upon them. It can be shown that this division of the tax $P'A$ between the two shares $P'B$ and BA is in the ratio of the elasticity of supply to the elasticity of demand. Thus, the elasticity of demand is given by proportionate change in demand divided by the proportionate change in the price to the buyers. That is to say, the elasticity of demand E_d is given by



Amount of Good Demanded/Supplied
FIG. 7.1

$$\frac{MM'}{OM} \Big/ \frac{P'B}{PM}$$

Similarly, the elasticity of supply is given by the proportionate change in supply divided by the proportionate change in price to the sellers. That is to say the elasticity of supply, E_s is given by

$$\frac{MM'}{OM} \Big/ \frac{BA}{PM}$$

Therefore, $$\frac{E_s}{E_d} = \left(\frac{MM'}{OM} \Big/ \frac{BA}{PM}\right) \Big/ \left(\frac{MM'}{OM} \Big/ \frac{P'B}{PM}\right)$$

$$= \frac{P'B}{BA}$$

$$= \frac{\text{Incidence on Buyers}}{\text{Incidence on Sellers}}.$$

If the tax is imposed upon the buyer, the demand curve would shift lfte and downwards to D_1D_1'. The buyers would then pay a price of

AM' to the sellers and a tax *P'A* per unit to the authorities. The resultant incidence on the two parties will remain unchanged. ***It can be shown that even when the tax is ad valorem (that is, proportional to the price of the commodity), the incidence of the tax shall be shared by the buyers and the sellers in the ratio of the elasticity of supply to the elasticity of demand.*** The only difference here will be that the tax per unit will be different for different supply amounts. The formula

$$\frac{\text{Buyer's Share of Incidence}}{\text{Seller's Share of Incidence}} = \frac{E_s}{E_d}$$

shows that as the elasticity of supply increases in relation to elasticity of demand, the incidence will be more on the buyer and vice versa. Thus, if the commodity taxed is being produced under constant returns,

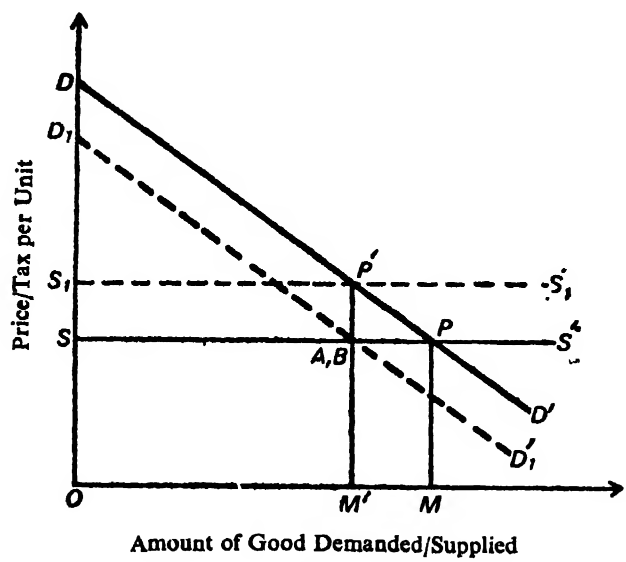


FIG. 7.2

it follows that the supply curve will run parallel to *X*-axis, and the elasticity of supply will tend to be infinity. In that case the incidence of the tax will lie wholly on the buyer. This will happen even when the tax is imposed upon the buyer (in which case the demand curve will shift downwards). Figure 7.2 illustrates this phenomenon and it is seen that here the points *A* and *B* coincide, so that *P' B*=*P'A*. Also note that here per unit tax will not vary even if the tax is not specific but ad valorem because the sale price by the sellers, net of tax, remains unchanged.

The tax will be fully borne by the buyers if the demand elasticity is zero (in the ratio E_s/E_d, the denominator becomes zero See Fig 7.3). Here the demand curve will run parallel to Y-axis and an upward shift in the supply curve will automatically mean an equivalent increase in the price being paid by the buyer. If the tax is ad valorem, say t per cent, the price will increase by exactly t per cent because the quantity demanded and supplied remains unchanged.

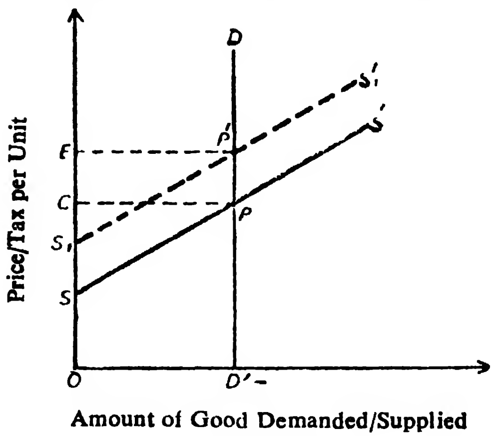


FIG. 7.3

It can be shown in the same way that if the elasticity of supply is zero, or if the elasticity of demand is perfect, the sellers will bear the full incidence of the tax (See Figs. 7.4 and 7.5.).

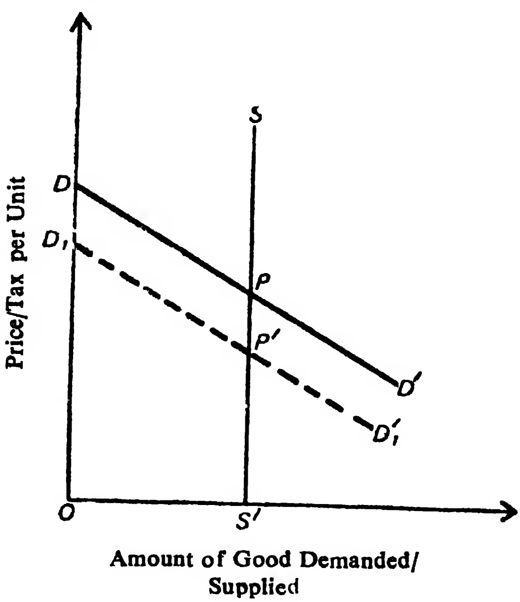


FIG. 7 4

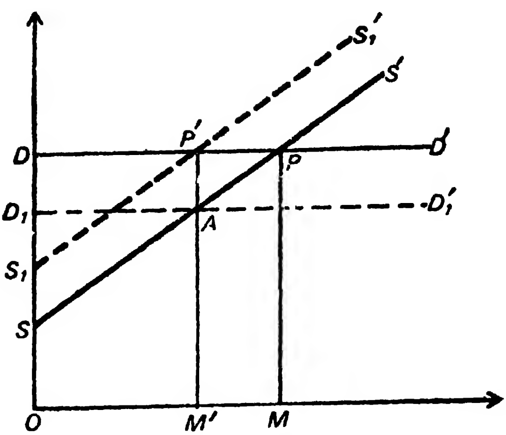
Dalton shows[9] that in absolute terms the incidence of a commodity tax on the buyers will be given by $\frac{tE_s}{E_s+E_d}$ where t is the tax per unit (it may be ad valorem or specific) and the share of the sellers will be given by $\frac{tE_d}{E_d+E_s}$. He generalizes it to the case where different rates are imposed upon a number of different sources of supply. If, for example, there are n sources

[9] H. Dalton, *Public Finance*, Notes to Chapters VII and VIII.

of supply with supplies of $x_1, x_2 \ldots, x_n$, and if they have the elasticities of supply $e_1, e_2, e_3, \ldots, e_n$ respectively, and if the respective tax rates upon these supplies are $t_1, t_2, t_3, \ldots, t_n$, then the incidence of the tax upon the buyers will be given by

$$\frac{\sum_{i=1}^{n} t_i e_i x_i}{E_d \sum_{i=1}^{n} x_i + \sum_{i=1}^{n} e_i x_i}$$

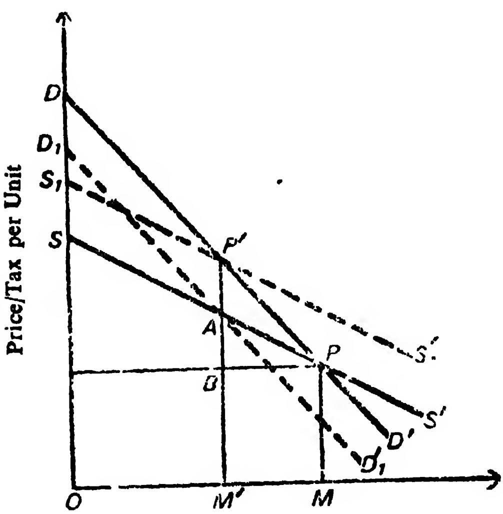
where E_d is the elasticity of demand.



Amount of Good Demanded/Supplied

FIG. 7.5

It should be noted that in some cases, the price of a commodity may increase by more than the amount of the tax levied on it. It would happen, for example, in the case of a commodity which is subject to the law of increasing returns (See Fig. 7.6). An imposition of a tax in this case reduces the amount supplied and purchased, the average cost of production increases and that adds to the upward shift in price. In Fig. 7.9 the price for the consumer increases by $P'B$ which is more than the tax amount $P'A$ per unit. Similarly, the sellers may try to pass both the tax and the loss of the interest which they suffer by first paying the tax to the authorities and then collecting it later from the buyers. Dalton says that in this case, the share of the buyers would



Amount of Good Demanded/Supplied

FIG. 7.6

be given by $\frac{(t+i)E_s}{E_s+E_d}$ where i is the interest loss to the seller. If this price rise for the buyer is more than the tax amount, it follows that then

$$\frac{(t+i)E_s}{E_s+E_d}>t,$$

that is
$$\frac{t+i}{t}>\frac{E_d+E_s}{E_s}$$

which means
$$\frac{i}{t}>\frac{E_d}{E_s}$$

In other words, a greater loss in interest, a smaller elasticity of demand and a greater elasticity of supply will work towards increasing the price more than the tax amount. Still another possibility under which the price rise may be more than the tax amount will be when the competitive market is converted into a monopolistic one by the sellers through some form of combination. In that case they will be able to restrict the supply and raise the price further.

To summarize the role of demand and supply elasticities in the division of a commodity tax incidence between the buyers and sellers under competitive conditions, we may state the following. Greater the elasticity of demand, smaller will be the share of the incidence borne by the purchasers. Supply however may have a positive (upward) or a negative (downward) slope. In the former case, with higher elasticity of supply, the share of the buyer will be more. In the latter case, on the other hand (in the case of increasing returns), the share of the buyers will increase as the elasticity of supply becomes *smaller.* It must also be noted specifically that the treatment of the theory of tax shifting runs on the assumptions that the buyers and sellers have already achieved their respective equilibrium positions and that the sellers work with the objective of maximum profitability. Much difference to the above conclusions will be made if the above assumptions are dropped.

The above analysis of the incidence of a tax on a commodity can be recast in more formal algebraic terms also. We shall first take up the case of a unit tax on the commodity under consideration in a competitive market.

Let the demand and supply functions be given by $P=p(q)$ and $S=s(q)$ respectively. Now let a tax of t per unit be imposed. If it is levied on the buyers the post-tax equilibrium would be given by

$p(q)-t=s(q)$. And if it is levied on the sellers, we get the post-tax equilibrium as $p(q)=s(q)+t$ which is the same thing as

$$p(q)-t=s'(q) \qquad \ldots (1)$$

If we differentiate (1) with respect to t, we can get change in equilibrium output in response to t. Thus

$$p'(q)\frac{dq}{dt} - 1 = s'(q)$$

or

$$\frac{dq}{t} = \frac{1}{p'(q)-s'(q)}$$

Differentiating the demand function with respect to t, we get

$\dfrac{dp}{dq} = p'(q)\dfrac{dq}{dt}$, in which we substitute the value

of $\dfrac{dq}{dt}$ and get $\dfrac{dp}{dt} = \dfrac{p'(q)}{p'(q)-s'(q)}$

which is the rate at which price changes when the commodity under consideration is subjected to a specific tax of t per unit.

The above generalised case can be applied to that of linear demand and supply functions. Let the linear demand and supply functions be respectively $P=a+bq$ and $S=m+nq$. Then $p^1(q)=b$ and $s^1(q)=n$, so that

$$\frac{dp}{dt} = \frac{b}{b-n}.$$

And for a unit tax t, change in price $\Delta P = \dfrac{tb}{b-n}$.

To approach the problem from a different angle, we note that in pre-tax equilibrium $a+bq=m+nq$, from which the pre-tax equilibrium output is $\dfrac{a-m}{n-b}$ and therefore pre-tax equilibrium price

$$P_o=a+bq=a+b\frac{a-m}{n-b}$$

The post-tax equilibrium is given by $a+bq-t-m+nq$, from which output s $\dfrac{a-m-t}{a-b}$ and therefore post-tax equilibrium price

$$P_1=a+b\frac{a-m-t}{n-b}.$$

Hence increase in price on account of tax t per unit is

$$P_1-P^{\circ}=\frac{bt}{b-n}$$

Now let us take the case of an ad valorem tax levied at the rate of tP so that post-tax equilibrium becomes $(1-t)p(q)=s(q)$, which may be differentiated with respect to t to get the value of $\frac{dq}{dt}$.

Thus we get $p'(q)\frac{dq}{dt} - p(q)-tp'(q)\frac{dq}{dt} = s'(q)\frac{dq}{dt}$

from which $\frac{dq}{dt} = \frac{p(q)}{(1-t)p'(q)-s'(q)}$.

Substituting the value of $\frac{dq}{dt}$ in $\frac{dp}{dt} = p'(q)\frac{dq}{dt}$, we get

$$\frac{dp}{dt} = \frac{p(q).p'(q)}{(-1t)p'(q)-s'(q)} = \frac{p\,(q)}{(1-t)-s'q/p'(q)}$$

Note that if an ad valorem tax at the rate Tc is levied on cost, then it can be worked out to show that

$$\frac{dp}{dTc} = \frac{s\,(q)}{1-(1+Tc[s'(q)/p'(q)\ ]}$$

The conclusion of ad valorem tax on demand side can be applied to the case of linear demand and supply functions. Thus with demand function $P=a+bq$ and supply function $S=-m+nq$,

$$\frac{dp}{dt} = \frac{a+bq}{(1-t)-n/b}.$$

Alternatively, in pre-tax position, equilibrium output is

$\frac{a-m}{n-b}$, and equilibrium price P_0 is $a+b\,\frac{a-m}{n-b}$.

In post-tax equilibrium $(1-t)(a+bq)=m+nq$, output is

$\frac{a(1-t)-m}{n-b(1-t)}$ and therefore post-tax equilibrium price

$$P_1=a+b\,\frac{a-at-m}{n-b+bt}.$$

Accordingly, increase in price $\Delta P=P_1-P_0$

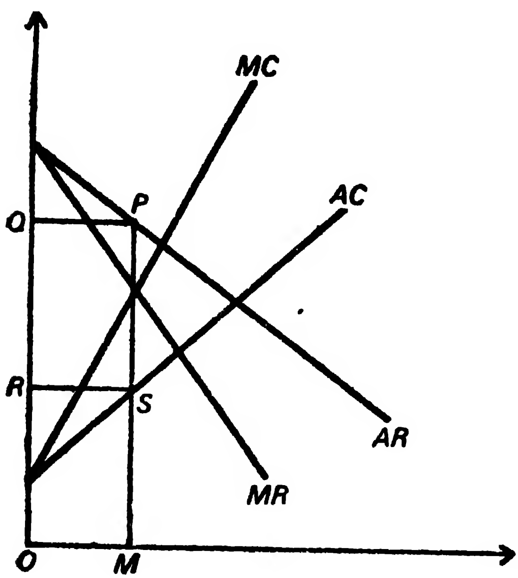
$$= b\,\frac{t(bm-an)}{(n-b)^2+t(nb-b^2)}$$

It can be shown that if an ad valorem tax at the rate of Tc on cost is levied, then

$$\Delta P=b\,\frac{Tc(bm-an)}{(n-b)^2+Tc(n^2-nb)}$$

Incidence of Some Particular Taxes

(1) *A Tax on Monopoly*. A monopolist, by definition, fixes the output and supply price of his product so as to get the maximum possible profits, which in turn are given by a position where marginal cost equals the marginal revenue ($MC=MR$). Now, if a tax is imposed upon monopoly profits, the monopolist cannot choose a better position of supply and price so as to increase his profits out of which to pay the tax. Actually he is supposed to have chosen the maximum profit position even if no tax on monopoly profits is imposed. This conclusion remains valid whether the tax on monopoly profit is a lump sum or a proportionate tax. We can also say that imposition of such a tax does not shift the demand or supply curve and so the sale price of the commodity does not change. Without a sale price variation, obviously, the tax cannot be shifted. Thus, in Fig.7.7 the monopoly profit,in the absence of a tax, is given by the area $QPSR$. If the authorities collect a part of this profit by way of taxation, the monopolist has no means of shifting the tax on to the consumers. This is because the positions of the cost and revenue curves cannot shift to his advantage and he cannot collect a pre-tax profit larger than $QPSR$. Had it been possible for him, he would have done o even in the absence of satax.



Amount of Good Demanded/Supplied
FIG. 7.7

If, however, a tax is imposed on the sales (specific or ad valorem) or on the buyers, the supply or demand curves will shift accordingly and the tax incidence will be shared (provided the monopoly product is not subject to constant returns).

As in the case of competition, we can put the analysis of incidence of commodity taxation under monopoly also in algebraic terms. We already know that for the demand function $P=p\ (q)$, the change

in price on account of a per unit tax t is given by

$$\frac{dp}{dt} = p'(q)\frac{dq}{dt}.$$

Now in order to get the value of dq/dt, we proceed as follows. The total revenue function is $TR = q.p(q)$, and therefore the marginal revenue function

$$MR = \frac{d(TR)}{dq} = q.p'(q) + p(q).$$

Similarly, the total cost function [for the initial cost function $S = s(q)$] is given by $TC = q.s(q) + tq$ and therefore the marginal cost function is

$$MC = q.s'(q) + s(q) + t$$

Now in monopoly equilibrium, $MR = MC$, which gives
$q.p'(p) + p(q) = q.s'(q) + s(q) + t$.
Differentiating with respect to t, we get

$$\frac{dq}{dt}.p'(q) + q.p''(q)\frac{dq}{dt} + p'(q)\frac{dq}{dt} = q.s''(q)\frac{dq}{dt} +$$

$$s'(q)\frac{dq}{dt} + s'(q)\frac{dq}{dt} + 1$$

or $$\frac{dq}{dt} = \frac{1}{2[p'(q) - s'(q)] + q[p''(q) - s''(q)]}$$

Substituting this value of $\frac{dq}{dt}$ in $\frac{dp}{dt} = p'(q)\frac{dq}{dt}$, we get

$$\frac{dp}{dt} = \frac{p'(q)}{2[q'(q) - s'(q)] + q[p''(q) - s''(q)]}$$

If the demand and supply functions are linear and are given by $P = a + bq$ and $S = m + nq$, then $p'(q) = b$ and $s'(q) = n$, so that

$$\frac{dp}{dt} = \frac{b}{2[b - n]} = \frac{1}{2[1 - n/b]}$$

and for a tax t per unit the change in price is

$$\triangle P = \frac{t}{2[1 - n/b]}.$$

Note that in this case the change in monopoly price depends upon the slopes, b and n of the demand and supply curves. For example,

under constant returns, $N=O$ so that $\triangle P=\frac{1}{2}t$, that is, the price variation is half of that under perfect competition. Under diminishing returns, b is negative and n is positive, so that n/b is negative and $\triangle P<\frac{1}{2}t$. Under increasing returns, both b and n are negative, so that n/b is positive. For stable equilibrium under increasing returns, $|b|>|n|$ implying that $n/b<1$. Now given that $n/b>0$, but less than 1, we find that the value of $\triangle P$ depends upon the ratio n/b. If n/b is $=\frac{1}{2}, \triangle P=t$; if $n/b<\frac{1}{2}, \triangle P<t$; if $n/b>\frac{1}{2}, \triangle P>t$. To put it differently, $\triangle P$ varies in the same direction as the numerical value of n and inversely with the numerical value of b.

Alternatively, in pre-tax situation $P=a+bq$, so that total revenue function is $TR=aq+bq^2$ and $MR=a+2bq$. Similarly, $MC=m+2nq$. Now in pre-tax equilibrium $a+2bq=m+2nq$ from which pre-tax output is $q_0=\dfrac{a-m}{2(n-b)}$ and pre-tax price is

$$P^{\circ}=a+b.\frac{a-m}{2(n-b)}.$$

On the other hand the post-tax demand function is given by $P=a+bq-t$, from which total revenue function is $TR=Pq=aq+bq^2-tq$, and $MR=a+2bq-t$.

Therefore, post-tax equilibrium is $a+2bq-t=m+2nq$

from which post-tax output $q_1=\dfrac{a-t-m}{2(n-b)}$

and therefore post-tax price $P_1=a+b.\dfrac{a-t-m}{2(n-b)}$

Therefore $\triangle P=P_1-P_0=\dfrac{bt}{2(b-n)}=\dfrac{t}{2(1-n/b)}$.

In this case the change in price is one half of that under competition.

Now let us consider the case of ad valorem tax under monopoly. As before, let the demand function be $P=p(q)$ so that

$$\frac{dp}{dt}=p'(q).\frac{dq}{dt}.$$ Further let the post-tax demand function be $P=(1-t).p(q)$ from which total revenue function is $Pq=(1-t).p(q).q$, so that marginal revenue function $MR=(1-t)[q.p'(q)+p(q)]$. Similarly, let the average cost function be $S=s(q)$, so that total cost function $Sq=s(q).q$ and marginal cost $MC=s'(q).q+s(q)$.

In equilibrium $MR=MC$ that is $(1-t)[q.p'(q)+p(q)]=s'(q).q+s(q)$.

Differentiating with respect to t, we can get $\frac{dq}{dt}$.

$$(1-t)\left[q.p''(q).\frac{dq}{dt}+p'(q).\frac{dq}{dt}+p'(q).\frac{dq}{dt}\right]-$$
$$\left[q.p'(q)+p(q)\right]=q.s''(q).\frac{dq}{dt}+s'(q).\frac{dq}{dt}+s'(q).\frac{dt}{dt}.$$

from which

$$\frac{dq}{dt}=\frac{q.p'(q)+p(q)}{2[(1-t)p'(q)-s'(q)]+q[(1-t)p''(q)-s''(q)]}$$

Substituting the value of $\frac{dq}{dt}$ in $\frac{dp}{dt}=p'(q).\frac{dq}{dt}$, we get

$$\frac{dp}{dt}=\frac{p'(q)\,[q.p'(q)+P(q)]}{2[(1-t)p'(q)-s'(q)]+q[(1-t)p''(q)-s''(q)]}.$$

Let us apply the above conclusion to the case of linear demand and supply functions $P=a+bq$ and $S=m+nq$ so that $p'(q)=b$, $p''(q)=0$, $s'(q)=n$ and $s''(q)=0$.

Then $\frac{dp}{dt}$ becomes

$$\frac{b[q.b+(a+bq)]}{2[(1-t)b-n)]}=\frac{a+2bq}{2[1-t-n/b]}.$$

Note that here the numerator is equal to marginal revenue.

Alternatively, the pre-tax equilibrium $MR=MC$ is given by

$$a+2bq=m+2nq$$

from which pre-tax output $q_0=\frac{a-m}{2(n-b)}$

and pre-tax price $P_0=a+\frac{b(a-m)}{2(n-b)}$.

Similarly, post-tax equilibrium is given by

$$a(1-t)+2b(1-t)q=m+2nq$$

which gives post-tax output $q_1=\frac{a-at-m}{2[n-b+bt]}$.

and post-tax price $P_1=a+\frac{b}{2}\left(\frac{a-at-m}{n-b+bt}\right)$

Hence change in price

$$\Delta P=P_1-P_0=\frac{b}{2}\left(\frac{a-at-m}{n-b+bt}-\frac{a-m}{n-b}\right)=\frac{b}{2}\left(\frac{t\,(mb-an)}{(n-b)^2+t(nb-b)^2}\right)$$

In case of an *volorem* tax at the rate of Tc on cost, the change in price becomes

$$\Delta P_1=\frac{b}{2}\,\frac{Tc[bm-an]}{(n-b)^2+Tc(n^2-nb)}$$

(2) *A Tax on Oligopoly.* Similar considerations apply to the case of a tax on oligopoly. An oligopolist is confronted with a demand curve which has a kink at the prevailing market price. Demand at prices higher than the one prevailing in the market is quite elastic, because if the oligopolist under consideration raises his price he is not followed by others. On the other hand if he reduces his price he is followed by others and therefore the demand at lower prices is quite inelastic for his supply. This produces a kink in the demand curve and a vertical jump in the marginal revenue curve. So long as *MC* curve passes through this vertical portion of *MR* curve, the price and output of the oligopolist remain unchanged. Therefore, if the authorities impose a *specific or an ad valorem* tax which does not raise the *MC* curve so as to make it move out of this vertical range of the *MR* curve the incidence of the tax is borne by the oligopolist. In effect, this amounts to the seller facing a demand with zero price elasticity. On the other hand, if the tax is high enough to push the *MC* curve beyond this vertical range of *MR* curve, the price would rise and a part of the tax would be shifted to the consumers. A lump sum tax, it would be noted, does not shift the demand or the cost curves of the oligopolist and therefore the incidence of this tax remains on the oligopolist firm itself.

(3) *Customs Duties.* Customs duties are like commodity taxes. Here also the general rule is that a tax on a commodity is shared between the buyers and the sellers in the ratio of elasticities of supply and demand. Therefore what matters is the actual values of these elasticities, given the freedom of trade. These days, for example, the demand for petroleum products is sufficiently inelastic while supply is sufficiently elastic. The petroleum producing countries of the Middle East can take a concerted action to restrict supplies if the price offered is reduced. Thus, they can raise the export price of petroleum either directly or through imposing export duties and thereby make the foreigners pay. On the other hand, if the oil importing countries impose import duties on petroleum, then, for the reasons stated just now, these are least likely to be borne by the exporting countries.

However, the case of other primary producing countries is a different one. We notice that over the last few decades the situation has been changing in such a way that the dependence of the developed countries upon these primary products has been decreasing. The developed countries have created quite a few substitutes for agricultural and mineral raw materials. They have also developed their agriculture and industry in such a way that instead of being dependent upon import of food items they are having export surpluses in

a number of these goods. The result is that import duties on these goods by the developed countries or export duties by the underdeveloped countries tend to be borne by the exporters of these goods. To put it differently, the demand for these goods is more elastic then the supply. The picture is quite reverse with regard to the manufactured goods, especially of the more sophisticated variety. In their case, the developed countries have adequate markets within their own countries, while the underdeveloped countries have to depend upon these imports. Duties on such goods also, therefore, tend to be borne by the underdeveloped countries.

While considering the case of any particular export or import duty, note must be taken of the coverage of the market also. If in the case of an import duty, the share of the importing country in the world demand is quite small, the import duty will be chiefly borne by the importing country since any reduction in its demand will hardly make an appreciable difference to the total demand to bring its international price down. The same conclusion may be reached by mentioning that the supply elasticity in this case is very high. But if the importing country has a major share in the world imports, a reduction in the demand for that good will have the tendency to reduce the price of the imported good. The incidence of the import duty will then be, at least partly, upon the foreigners. Similar considerations hold in the case of export duties. A major exporter of a commodity, which is essential for others (and therefore has an inelastic demand), can impose an export duty whose incidence will partly or wholly shift to the foreigners. A small exporter cannot do that.

The above analysis runs in terms of the assumption of a free trade. To the extent the trade is not free and there are monopolistic types of restrictions either by privately owned firms or by governments in the form of quotas etc., the operation of demand and supply forces is restricted to particular segments of the world market and therefore the shifting of tax incidence has to be considered in the context of these segmented markets.

(4) *A Tax on Profits.* Theoretically all profits may be taxed without any exception and by the same schedule of rates. In such a case, obviously the tax cannot be avoided by shifting the entrepreneurship from one line to another. However, even here in certain industries the elasticity of demand for the products may be sufficiently low so as to permit a shifting of the tax incidence on to the buyers of those products. If that happens, the profits net of tax in those lines will be higher than in other competing lines and therefore in the long run, the employment of resources will move from other lines into these,

raising the profit rate in the former. This way a part of the incidence may be said to have shifted to the buyers in some lines and the effect of taxes would include the shifting of the resources. To the extent that a tax *partly* or *fully* cannot be shifted to the buyers, saving and investment may be discouraged. But that will be a part of the effects of taxation and not the incidence.

But in general, however, it is nearly impossible to identify all sources of profits, estimate them and tax them evenly. In effect, therefore, taxes get levied in a discriminatory way. Some profit incomes are either not taxed, or evade taxation. In the short run, therefore, the taxed profit incomes fall in comparison with the 'untaxed ones'. Whether the tax-payers are able to shift the tax incidence on to others or not depends upon the relevant elasticities of demand and supply of the goods and services through which the profit incomes are being derived, and the demand and supply elasticities of the inputs of these goods and services. In the long run, it may be possible, in some cases, to shift the resources out of the taxed lines and if that happens, a part of the tax may be shifted on to others.

(5) *Taxes on Property.* Property may be divided into two parts: (*i*) durable consumption goods, and (*ii*) capital goods. Durable consumption goods will include houses (occupied by owners),[10] cars, furniture, jewellery, etc. If the authorities tax these durable goods, the current owners will be expected to pay the taxes. If they do not recover these taxes from others, they will suffer a loss in satisfaction from the use of these durable goods. Now the possibility of a tax shifting exists only if these durable goods are sold or purchased. Looked at from the point of view of the existing owners of these goods, the only possibility of tax shifting that could be considered is that of forward shifting. From the point of view of the new owners who are yet to purchase these goods, there exists the possibility of backward shifting only. Now since the new owners are to estimate the net satisfaction which they can get from their purchases, they would reduce the prices they are ready to pay. It appears highly unlikely that the prices of these goods would rise, unless there is a great expectation of inflationary rise in prices. Even then, it must be remembered that the prices after the taxes would be lower than what they would have been without the taxes. We may conclude, therefore, that in this case we should expect only a backward shifting of the tax incidence from the purchasers to the sellers. If these items are not

[10]Houses which are rented out are here included in the categoty of capital goods.

sold, the incidence lies on the existing owners; if they are sold, the incidence will again be upon the existing owners because the purchasers would capitalize these taxes. However, if the taxes are only expected and their net amount is yet not known, it is possible that out of ignorance or inaccurate expectation full capitalization of the tax may not take place.

The picture is clearer in the case of capital goods. Let us first consider bonds, securities and such like financial assets. The sellers and purchasers of such financial assets are more aware of the tax rates—current and the expected—and they are more used to take these forces into account. In such a case, if a tax is imposed upon any particular set of investments, the funds will move out of those lines into the non-taxes ones till the rates of return in those other lines fall and those in the taxed lines increase and the net rates of return are equated. This means that in the taxed lines, it is the gross rates of return which will be higher. Since the returns are paid by the borrowers, the incidence will lie on them. However, if all lines of investment are evenly taxed, a shift in the lines of investment is not expected. In such a case, the incidence of tax will depend upon the relative strength (or elasticity) of demand and supply of investment funds. Actually, in the first case, the elasticity of supply of funds was very high (nearly perfect) in the taxed lines and that is why the tax was borne by the borrowers of the funds.

The other type of property in the category of capital goods would be the means of production like machinery, equipment, etc. Here also clearly the possibility of backward shifting of tax exists through capitalization. The extent to which this backward shifting may take place will obviously depend upon the elasticities of demand and supply of the goods being taxed. Under conditions of scarcity, or conditions of strong demand, backward shifting will be rather difficult. However, since the capital goods are used to produce goods for the markets, therefore, here a means exists to shift the tax forward also.

To analyze the possibility of forward shifting of such a tax, we should first see whether the tax is added to the fixed cost or the variable cost of production. Let us first consider the case of short run in which such items like machinery etc., are part of fixed factors of production and therefore a tax on such items will add to the fixed costs only. Marginal cost, which is based upon variable costs only does not change. It means that in the short run, the supply conditions do not change since the suppliers will be basing their decisions to change the supply with reference to marginal cost and marginal revenue only and they are not changing. In the long run, all

factors are variable which means that the tax under consideration becomes really a tax on variable factors of production and therefore adds to the marginal cost of output. This, accordingly, pushes up the price of the product and a forward shifting may take place.

However, it is quite possible that in the case of a tax on capital goods, the shift of incidence may cover *more than one stage*. Thus, for example, on account of a tax on buildings, a machine building firm (which is housed in a building and therefore finds that its total expenses have gone up) may be shifting a part of the tax on to the buyers of its products. The machinery so purchased, however, is meant to be used for further production and since that raises the cost of production of the final goods, a further shifting of the tax to the consumers may take place.

(6) *A Tax on House Rents.* A tax on house properties as such will be subject to usual forces of tax capitalization. The purchasers of houses will try to shift the tax back through a reduction in the initial purchase prices. However, since houses are often rented out also, a further possibility of shifting the tax on to the tenants also exists. In the short run the supply of the houses is sufficiently inelastic and would work towards keeping the incidence on the house owners However, if the demand for houses is also inelastic, a forceful tendency for house rents to go up will also exist simultaneously. The net result regarding the sharing of the tax incidence will depend upon the relative strength of the two short-term elasticities. In the long-run, however, if investment in houses becomes less profitable, further construction of houses will be discouraged and therefore the tax incidence will again tend to settle on the tenants.

If instead of houses as such, a tax is imposed on house rents, its sharing will follow the usual rule of elasticities of demand and supply. Again, to the extent that the tax incidence is borne by the house-owners, investment in houses will be discouraged. This will reduce the supply of houses in the long-run and would raise the house rents further. It appears, therefore, that unless all investment incomes are taxed simultaneously, a tax on house rents will tend to push the incidence on to the tenants.

(7) *Inheritance and Gift Taxes.* Different views are put forth regarding the incidence of inheritance taxes. According to some people the incidence is upon the testator who is leaving behind the estate to be taxed. It is stated that the only difference between a straightforward tax on this inheritance and other property is that in the former case the tax is paid only after the death of the testator. It is also argued that the testator may have planned to save additionally so as

to leave a given value of the after-tax estate to the successors, in which case again the incidence should be considered to have fallen on him.

However, these arguments are misplaced and also tend to confuse the issue. *Firstly*, it must be remembered that the dead do not pay taxes. And so the incidence of the inheritance taxes cannot be on the testator. Also the tax does not discriminate between two situations where in one the testator saved additionally to leave a given value of after-tax estate and in the other he did not. Furthermore, the inheritance tax is levied not on the value of the estate as such but on the portion of it inherited by a successor The rate of inheritance tax will depend upon the value of the inheritance and the other relevant factors connected with the tax paying capacity of the successor. The fact that the incidence of the tax is on the successor can be seen simply by comparing the inheritance going to a successor with and without the tax. If the tax is raised, or reduced, it is the successor who will be immediately affected. As Adam Smith says: "Taxes upon the transference of property from the dead to the living, fall finally as well as immediately upon the person to whom the property is transferred."[11] If the testator changes his policy with regard to saving effort or the division of the property in his will, it will be a part of the effects of this tax and not the incidence itself.

Similar considerations apply to the case of gift taxes also. A comparison of the two situations, namely the addition to the resources of the gift recipient with and without a tax would clearly show that the incidence of a gift tax lies not on the giver but on the one who receives it. The argument is further strengthened by the fact that the tax schedule is related to the amount of each gift individually (or the total gifts which one might *receive*) and not to the total gifts which one might be *making*. The possibility of gift-giver revising the gift amount in the light of the possible tax would fall in the realm of the tax effects.

(8) *Tax on Net Income*. Net income here refers to the income of an individual or family, as the case may be, net of the expenses incurred for earning that income. It is not to be equated with receipts during a given period of time. Now such a tax on income may be specific or general, that is to say incomes from particular sources may be taxed or all incomes may be taxed irrespective of the sources. Also income taxation may discriminate between 'earned' and 'unearned' incomes and the schedules of tax rates may be different for the

[11]Adam Smith, *The Wealth of the Nations*, The Modern Library Edition, 1937, p. 813.

same amounts of income but of different kinds.

If income from specific sources is being taxed, then certainly there will be a tendency for work effort to shift from there to other lines of employment. Those left in the employments, income from which is taxed, will try to shift the incidence of the tax through raising the supply prices of their products. Unless they happen to belong to the 'non-competing groups,' they will be able to shift some of the tax on to others.

However, a tax on income in general is more likely. In this case, it will not be possible to avoid the tax by shifting the employment. Here the only way in which the tax may be shifted will be the one where the income net of tax of some people is pushed below 'subsistence'. In all other cases, the tax incidence will lie upon the tax assessees and it will be so even if the rates of taxation are progressive since higher tax rates can be avoided only by not earning more. Further, if a discrimination in tax rates exists as between earned and unearned incomes, even that would not make any difference to the tax incidence. Shifting of income from earned into unearned categories cannot take place so as to lighten the burden of taxation since it is an impractical proposition.

If, however, the tax administration is lax, so that some categories of income earners are able to evade the tax, then it is a different question. In that case, on account of ineffective tax administration, it is amounting to taxing some sources of income and leaving others out.

Additional Factors Influencing Tax Shifting

There are quite a few factors which have an active influence in determining the demand and supply forces in the case of particular taxes and therefore in the determination of the tax incidence.

Firstly, we have to consider the type of tax. For example, in the case of a sales tax, the sellers quite often adopt the practice of quoting the sale price as such and once the bargain has been settled, add the sales tax in the bill. Such a practice tends to break the resistance of the buyers and it becomes easier to shift the incidence of the tax on to them.

Secondly, it sometimes happens that with a long usage or advertising and publicity, some prices come to be fixed and accepted as normal, tax or no tax. It is not easy to shift the tax here by means of a price rise. However, a possibility may exist to shift the tax by deterioating the quality or reducing the size of the taxed object. Restaurants quite often adopt the policy of reducing the sizes of various eatables as a substitute for raising prices. Sometimes, the market may be con-

trolled by a small group of sellers and by convention it may be difficult to change the price unless everyone does so. An example is that of newspapers having the same price in a city. In this case, it will be easier for all of them to raise the price or if any one of them wants to do so, it would be better to reduce the number of pages or reduce the 'quantity' otherwise.

Thirdly, the shifting of a tax depends to a great extent upon the tax rate. If the tax is quite small and the market is competitive, the sellers may choose to absorb the tax in order to maintain the goodwill of the buyers. But such a practice is certainly less likely when the tax amount is a large one.

Fourthly, it will be more difficult to shift the tax to the buyers in the case of a commodity tax which has close and effective substitutes. The consumers will then have an easy means of shifting their demand if the price of the taxed good is raised. It means that the elasticity of demand for this good will be high and so the tax will have to be borne by the sellers. If this reduces the profit of the producers and the price of this good is raised by reducing its supply, then such a result will be in the realm of effects of the tax. If however, the substitutes are also taxed, then the shifting of the tax incidence will depend upon the general pattern of the demand elasticities for this group of commodities as a whole vis-a-vis the pattern of their supply elasticities.

Fifthly, in the case of goods taxation, the geographical coverage of a tax has a great influence in determining the incidence of the tax in the taxed area. Since the untaxed good will be available in the neighbouring areas, there will be a great resistance of the buyers to bear the tax incidence. The price of the good will therefore rise to an extent much smaller than would be the case if geographical area of the coverage was complete. In order to discourage buying of the taxed commodity in the neighbouring untaxed areas and bringing them in, the authorities often impose a 'use tax' on the taxed good if it is brought in from the untaxed areas.

Deficit Financing as a Hidden-Tax

Ordinarily deficit-financing is defined as that budgetary expenditure of the government which is financed by some non-revenue receipts (that is, borrowings, creation of cash or drawing down of cash balances). Some borrowings, however, may come out of genuine savings of the public and divert purchasing power from the private into government hands. These borrowings, therefore, do not add to the total demand and inflationary pressures in the market.

The Government of India believes that deficit financing should be defined in relation to its inflationary potential. Accordingly, our official definition does not cover all types of government borrowings but only the sale of treasury bills and drawing down of cash balances. It is argued that expenditure met by these sources adds to money supply and leads to an inflationary price rise.

In effect, therefore, deficit financing acts like a tax. In a tax the authorities take away a portion of purchasing power with the public and use it to acquire certain goods and services. Similarly, in deficit financing, the authorities create some purchasing power and then use it to acquire goods and services. This adds to the total demand in the market, prices go up and the public is able to buy less with the same money balances.

If deficit financing is a 'hidden-tax', who bears its incidence? It may be noted that an inflationary process widens income inequalities. Money incomes of workers, salaried people and rent recipients etc. do not rise as fast as prices and they lose in terms of 'real income'. On the other hand, money incomes of profit earners increase more than the corresponding increase in prices and therefore, in their case, both money and real incomes go up. It means that, in reality, deficit financing not only acts as a 'hidden-tax' by the authorities but also as a 'hidden-tax' by profit earners on the fixed income earners in the economy.

The Problem of Double Taxation

Every State is interested in spreading its tax net as wide as possible so as to have the power to increase its tax income either immediately or later if the need arises. Furthermore, every State has the right, at least theoretically, to tax its subjects equal to the amount of their resources. Accordingly, under the enthusiasm to tap all the available taxable resources, sometimes more than one State would try to tax the same incomes or other resources provided their respective jurisdictions permit this. This gives rise to 'double taxation'. Double taxation, in other words, is the case where two or more States concurrently tax the same tax-payers on account of the same subject matter of tax (such as income, property, etc.)

A country may adopt one or both of the following bases of imposing taxes. The first basis relates to the identification and selection of the taxable incomes and other resources in terms of the country of origin. Any incomes, for example, originating within the territorial jurisdiction of a government may be chargeable to taxation by that government. Here the government of a country would be taxing not

only its own subjects (individuals, companies, and institutions etc.) securing their incomes from within the national boundaries, but also the foreigners securing their full or part incomes from within the taxing country. The second basis is to tax the subjects of a government irrespective of their place of residence or the origin of their incomes. The taxable income or other resources of the subjects of a government may be originating partly or fully within the territorial jurisdiction of other countries.

The fact of double taxation generally arises on account of conflicting criteria adopted by different countries to levy the taxes. A country generally wants to tax the incomes and other resources of its subjects irrespective of where they are while it also wants to tax the incomes etc., originating within its territorial jurisdiction even when it accrues to foreigners (subjects of other governments). As a result, an economic unit, being subject of one government and getting its income from another country, may be subjected to a taxation by both the governments. This will be called double taxation.

It is sometimes argued that the fact of double taxation (in the sense of same income or resources being subjected to taxation more than once) need not involve two countries. Such double taxation is often found even within the same country. For example, in a partnership firm, the income and assets of the firm may be taxed and then the incomes and assets of the individual partners may be taxed additionally. Similarly, a corporation's or a joint stock company's profits may be taxed and then the dividends distributed to the shareholders, from the net-of-tax profits, may also be subjected to taxation. However, by usage and convention this problem of double taxation is ignored and only the case involving two or more countries is considered.

Different governments have recognized the problem of double taxation and various methods have been adopted to solve it. *Firstly*, two or more governments may enter into an agreement whereby it is ensured that the same subject matter is not taxed by two governments. This solution would be called avoidance of double taxation. Thus, for example, an agreement between countries A and B may stipulate that the basis of taxation would be the country of origin of the income to be taxed. In that case an economic unit getting an income from country A will not be liable to pay a tax on that very income in country B also even if it happens to be a subject of country B. On the other hand, if the agreement lays down that each government may tax its own subjects, a subject of country B will be taxed by that country only even if it gets an income from country A. It must, of course, be remembered that the avoidance of double taxa-

tion agreement does not benefit those subjects whose governments have not entered into these agreements. If country C does not have such an agreement with countries A and B then the subjects of C will not get this concessional treatment.

Secondly, two governments may enter into an agreement whereby the economic units liable to double taxation are provided partial relief. In this case, it may be recognized that each country has the right to tax its own subjects and also the incomes originating from within its boundaries, but when a foreign economic unit has been taxed by the host country, the home government would take that fact into account and would reduce its own tax bill to some extent. It is obvious that this relief from double taxation would generally be smaller than the one obtainable under avoidance of double taxation. Of course, nothing prevents a government from granting a tax relief to its subjects obtainable under a possible 'avoidance of double taxation' agreement. Another point to be noted is this. In the case of avoidance of double taxation, only one country imposes a tax on one subject matter. In the case of double taxation relief, one country imposes taxation at full rates and the other country at reduced rates. It is, therefore, conceivable that under double taxation relief, the actual tax liability of an economic unit from a particular income may turn out to be smaller than if there was full avoidance of double taxation. For example, let us assume that taxation in country A is very high, and in country B it is very low and country A also gives a very high rate of relief on foreign taxed incomes. A subject earning its income in country A would then be subject to a heavy tax bill, but if the same income is first earned in country B and a low tax is paid on it (followed by another low tax bill in country A on account of high tax relief), then the two tax bills of both countries A and B may turn out to be smaller. Generally, however, the relief given is about 50% of the tax paid to the foreign government, and therefore the total tax liability is not reduced.

Thirdly, a country may decide to give unilateral tax relief to its own subjects even when no tax agreement exists with other countries. In such cases, the home government would normally estimate the tax liability on that income on the assumption that income originated within the home country. Out of this tax liability the tax paid to the foreign government would be deducted and the balance would be billed as additional tax liability. The tax bill of the home government would be zero only if the tax bill of the foreign government exceeds or is equal to the 'unreliefed' tax bill of the home country.

India has entered into comprehensive agreements for the avoidance

of double taxation of income with several countries including Austria, Belgium, the Federal Republic of Germany, France, Japan and the Scandinavian countries. Negotiations with several other countries are in progress. An important objective in negotiating tax treaties with developed countries is to stimulate inflow of capital, technology, and personnel for accelerating economic development by removing those tax barriers which might inhibit such inflow. And the incidence of double taxation is quite a strong impediment in the way of inflow of foreign investment.

8 CLASSIFICATION AND CHOICE OF TAXES

In an earlier part of this book, we had the occasion to look into various characteristics of a good tax system as judged from various objectives of the society. However, even after these general considerations as to the objectives of the society and the principles involved in the distribution of tax burden etc., the crucial question of choosing between different possible taxes and their rate schedules remains. In this chapter, we shall therefore look at different kinds of taxes and their merits and demerits in terms of the objectives of equity, efficiency, simplicity, resource allocation and so on. It would have been ideal if each tax happened to contribute to some or all these generally accepted objectives. In that case, there would have been no conflict between different taxes and the job of the authorities would have been only to select that combination of taxes which yielded the "maximum" possible collective attainment of the goals of the society. Such, unfortunately, is not the case. Quite often a tax helps the economy along some of its objectives and militates against the others. In other words, a tax is usually a mixture of both advantages and disadvantages.

When we discuss the question of choice of taxes, we do not imply that the State has the full authority to recast its whole tax structure. Every existing tax structure, it must be remembered, evolves over history and leads to a particular mould of the economy. Accordingly, politically and economically, the choice of changing the tax structure is only within limits. The discussion regarding the merits and demerits of different forms of taxes is only meant to be a general guide indicating the variables which the authorities should keep in mind in their efforts at tax reforms. Also, it must be remembered that though we assume that State may choose any tax and any rate schedule, in practice it need not do so.

Generally, every tax variation has to have a political approval of the society (such as the approval of the legislature) before it can be adopted. Even then some tax modifications or variations can be unacceptable to the powerful sections of the people and the State may think it better not to levy them—even though on economic grounds it is desirable to do so. Furthermore, in theory, we generally assume that the government has an adequate and honest administrative machinery through which the tax system can be en-

forced. In practice, a government may find that its administrative machinery is not adequate for particular types of taxes and because of that fact these taxes cannot be adopted. Again, the cost of collection of some taxes may be so high as to make them impracticable.

Thus, we find that theory and practice of tax structure and policy can be at variance from each other, and quite often tax proposals, which theoretically are quite sound and desirable, may have to be left out from practical point of view. However, to the extent possible, the authorities must see to it that the taxes are designed in such a way as to reduce their ill effects to the minimum and strengthen their good effects to the maximum. It is in the light of these observations that we find it necessary to study some general classifications of the possible taxes and their relative merits and demerits.

SINGLE VS MULTIPLE TAX SYSTEM

Notwithstanding the above comment, a tax system comprising of only one tax has been advocated at times in the past. Partly this was due to the inadequate understanding of the working of a complex modern economy, and partly it was the result of the belief in the 'concentration theory of incidence'. Conceptual and analytical inadequacies also contributed to this type of reasoning.

One simple form of a single tax is the poll tax, or the 'head tax' which is imposed on a person simply because he is there in the society and not because he has an income, or wealth, or is following any particular trade or profession etc. According to this scheme, a poll tax is expected to be levied on each adult member of the society with the possible exemptions for the blind, deaf, insane, very old, and so on. It is claimed that a poll tax is almost neutral in terms of allocation effects. That is to say, the imposition of this tax does not distort the pattern of economic activity in the country. Since the disposable income of every tax-payer is reduced by a given amount, therefore, a direct effect on market demand and supply takes place. It is also claimed that the rate of poll tax can be adjusted to the needs of the government. Another point quoted in its favour is that in this system every member of the society contributes to the upkeep of the government. This makes this tax not only widespread, it also instills a sense of awareness and responsibility in the minds of the tax-payers regarding the activities of the government.

These arguments, however, are misplaced and lead us to wrong conclusions. It is highly unlikely that a poll tax would really be neutral in its market repercussions.

Firstly, we must know that in general there are inequalities in the distribution of income and wealth in the country. Such inequalities may be too large or just moderate, but they are seldom absent.

Secondly, the requirements (and therefore the marginal utility of income) of different members of the society are not equal and as a result, an *equal absolute reduction* (by way of a poll tax) in the disposable income of every tax-payer would hurt the poorer sections more than the richer ones.

While the richer sections may not change their consumption pattern and absolute demand for various goods, the poorer are most likely to do so. The richer sections however, are likely to reduce their savings and investment in order to pay the poll tax and maintain their consumption standards.

By itself, a poll tax is inequitable because it is more burdensome for the poor than for the rich It has no relation with the ability-to-pay of the tax-payer. A millionnaire would be paying the same tax as a poor peon or even a beggar. For this reason, this tax is also likely to militate against the principle of least aggregate sacrifice. Similarly, this tax cannot be justified on the basis of the benefits received principle because there is no *quid pro quo* between the State and the tax-payer under this tax system.

A poll tax is not likely to yield sufficient tax revenue for the public treasury because its rate would have to be fixed with reference to the poorest in the country. In other words, the rate of a poll tax cannot be very high; if it is, it will push many poor people to starvation.

In crude economies where national income mainly originated from agriculture, and where the majority of the people were more or less equally poor, a poll tax could be administratively feasible and economically acceptable. But even then, historically, poll tax has existed only in conjunction with other taxes especially those on land. The use of poll tax was there in ancient Greece, Rome, medieval Britain and even in some of the American colonies. In a modern economy, however, such a tax has no place.

Another form of a single tax was advocated by the Physiocrats of France in the 18th century. They created a theoretical justification for a single tax on agricultural rent. They believed that a tax could finally be paid only out of an economic surplus. Its incidence could not lie anywhere else. Furthermore, to them such an economic surplus or a 'net product' as they called it, could and did exist only in agricultural produce. Accordingly, all taxes would finally be borne by this agricultural surplus. To use modern terminology, they were believing in the 'concentration theory of incidence'. They, therefore, advocated that

the State ought to levy a tax only on agriculture and nowhere else.

As noted above, to the extent an economy's income originates from agriculture, such a tax is the only genuine one which may be chosen. In olden societies it was often found that agricultural taxation was quite adequate to meet the needs of the State and that other possible taxes were either not politically acceptable or were very low revenue yielding. It is for these reasons that income tax was not much in use in olden times, and taxes on handicrafts and trade were either not levied or were levied only to a limited extent.

The 19th century had an ardent advocate of a single tax in Henry George who wrote his famous book *Progress and Poverty* in 1879. Henry George provided a more sophisticated argument in favour of a single tax. He distinguished between 'economic rent' of land from other returns on labour and capital. Returns on labour and capital necessitate an effort on the part of the workers and investors and a tax on these returns would therefore discourage savings, investment, and other productive activities. However, with the progress of the society, land values acquired unearned increments in the nature of 'economic rent' and the society could therefore tax this benefit away without any adverse effect. The advocates of this single land tax would of course ask for a rate of 100% on the economic rent on an annual basis. Though in practice George's proposal remains unaccepted[1], there have also been other advocates of this single tax. Even as late as 1932, Harry Gunnison wrote a book *The Economic Basis of Tax Reform* justifying a single tax system.

A single tax on economic rent of land has many limitations.

Firstly, there are conceptual difficulties. It is not easy to distinguish between economic rent and 'business rent', that is a return which is attributable to investments of labour and capital in improving land.

Secondly, it is obvious that excepting in the case of improved lands, capital value appreciation (or unearned increment) may equally be associated with buildings, investments and other forms of wealth. In a modern economy, these other forms of wealth are assuming ever increasing importance. Why should then economic rent of land be chosen for a levy while other forms of capital gains remain exempted? And some forms of gains to the beneficiaries are so obviously good subjects of taxation such as gifts, inheritances, lotteries, and so on.

Thirdly, even if these conceptual and estimation problems were not there, and a single tax on economic rent of land could be imposed

[1]A land tax on economic rent is often one of the many taxes which a modern government imposes.

and collected, revenue yield from such a tax would be least likely to be adequate for the needs of a modern government.

Fourthly, this tax cannot be expected to help the economy in achieving its other objectives such as those of growth.

We may conclude by saying that a tax on not only economic rent of land but on all kinds of unearned increments stands justified. However, to use a single tax in the place of a large number of judiciously chosen taxes is not desirable.

This leads us to assert that any worthwhile tax system in a modern economy will be a multiple tax system. It can be easily seen why this must be so. *Firstly* as noted above, a modern economy is not one-objective economy. It tries to forge ahead simultaneously along the paths of growth, equitable distribution of income and wealth, economic stabilization, and so on. And since no single tax can be expected to help the economy on all fronts, a choice for a multiple tax system becomes inevitable. Different taxes contribute to the attainment of different objectives. Thus, some taxes would help in the redistribution of income and wealth more equitably. Some other taxes would help the economy in the direction of regional balanced growth. Still others may be needed so as to provide adequate revenue for the government treasury, and so on. A tax system comprising of a number of taxes, therefore, becomes essential in a modern economy where the objectives of the State happen to be many.

Secondly, income of a modern economy originates from many sources. It would be highly unjust to tax income originating from any one source and leave out others. Justice and equity would demand that the State should tax all the important sources of income in an equitable manner.

Thirdly, it is very likely that any single tax, while helping the economy in some objectives, would work against others. For example, a tax which tries to reduce income inequalities might discourage saving and investment and thereby retard capital accumulation and economic growth. It is necessary, therefore, that a judicious mixture of taxes be chosen so as to minimize their possible ill effects and strengthen their beneficial effects for the economy.

PROPORTIONAL VS PROGRESSIVE TAXES

A common classification adopted in taxation is that on the basis of degree of progression of a tax. A tax is called progressive when, with increasing income, the tax liability not only increases in absolute terms, but also as a proportion of the income. If, on the other hand,

the tax liability increases in the same proportion as the increase in income, then it is proportional taxation. It would be called a regressive tax if the tax liability, as a proportion of income, falls with the increase in income. The absolute tax liability, even in this last case, of course, may increase. We can say the same thing by using the term 'tax base'. The base of a tax is the legal description of the object to which the tax applies such as 'net income of an individual', 'the value of a property', and so on. The term 'tax rate' is used to denote the amount of tax per unit of the tax base. Accordingly, therefore, when the tax rate remains unchanged for each unit of the tax base, it would be called proportional. If on the other hand, the rate rises as the tax base increases, we have progressive tax and the tax is regressive if the tax rate diminishes as the base increases.

It will be noted that the presence of proportionality or progressiveness gives rise to a corresponding relationship between average and marginal tax rates. Average tax rate is computed by dividing the total tax liability by the total tax base. The marginal tax rate, on the other hand, is estimated by dividing the *change* in the total tax liability by the change in the total tax base. For example, if for an income of Rs 10,000 the tax liability is Rs 1,000 and for an income of Rs 11,000 the tax liability is Rs 1,320, then the average tax rate for the two incomes would be 10% and 12% respectively. The marginal tax rate would be the additional tax liability (viz. Rs 320) divided by additional tax base (namely Rs 1,000) i.e. 32%. In the case of proportional taxation, since by definition the average tax rate remains unchanged, the marginal rate always remains equal to the average rate. If the tax rate structure is progressive, then the marginal rate would be rising as the tax base increases and would lie above the average rate of tax. In the case of regressive tax schedules, both the average and the marginal tax rates fall as the tax base increases and accordingly the marginal tax rate lies below the average tax rate.

Another term "degressive taxation" is used to distinguish between certain forms of progressive rates. Degressive progression occurs when there is a declining degree of progression as the tax base increases.[2] Two forms of degression are generally found. In the first case, a certain amount of the tax base is exempted, and a single tax rate is applied to the rest. This exemption may be a flat one or a changing amount in relation to total income. Another form of degression is where the rate schedule does not rise fast enough as the tax base increases, more precisely where the degree of progression is not

[2]R. A. Musgrave, *The Theory of Public Finance*, p.1.

constant throughout so that the addition to tax rate becomes slower as the tax base increases. This sort of degression is often found in practice in the case of income tax.

It must be remembered that the concept of progressiveness as stated above is with reference to only the money (or money-equivalent) burden of a tax. It is not being translated into 'real burden' or the sacrifice which the tax-payers undergo. In terms of sacrifice, for example, a proportional income tax will be regressive because it would be involving a proportionately greater sacrifice of utility on the part of the lower income tax-payers. Actually, depending upon the rate at which marginal utility of income to tax-payers falls, even some degree of progressiveness in money terms might turn out to be regressive in its real burden.

Coming to the arguments for and against progressive, proportional and regressive taxes, it must be remembered that ideally the whole argument should run in two terms.

Firstly, as far as the burden of a tax on any individual tax-payer is concerned, it is better if we can measure it in terms of the sacrifice which a tax imposes upon the tax-payer.

Secondly, we have to look at a tax structure in terms of its various economic and social effects such as its effects in terms of economic growth, saving, investment, regional imbalances, and so on.

When we argue in subjective terms, that is in terms of the sacrifice which individual tax-payers undergo in paying the taxes, we come in contact with the ability-to-pay and benefits-received approaches. These approaches are intimately connected with the subjective formulation of the degree of progressiveness of a tax.

Arguments For and Against Proportional Taxation

Proportional taxation has been advocated mainly on grounds of our inability to decide upon a precise and appropriate degree of progression. It is argued that the case for progressive rates is based only upon the hypothesis that marginal utility of income is lower for the richer sections. It is claimed that this cannot be proved because utility, being a subjective thing, cannot be measured and inter-personal comparisons of utility are not possible. It follows that we cannot impose a large money burden upon the richer sections on grounds of sacrifice. This argument, it is obvious, is quite misplaced. It is true that we cannot *prove* on any objective basis that the marginal utility of income to a rich person is lower than it is to a poor one. It is true that interpersonal comparisons of utility are not possible on objective grounds. But it is a commonly known fact that mar-

ginal utility of income, like the marginal utility of any other particular good, falls as income increases. It can safely be assumed that the marginal utility of income to a poor person will be higher subject to the condition that his capacity to enjoy income is as much as that of the richer man. Even if it is not, over a time, the poor person also learns the use of additional income as well as the rich person does, provided he is allowed an increase in income on a long-term basis. If still the capacity to enjoy income differs from person to person, it can happen both between the poor and the rich.

To put it differently, capacity to enjoy income depends upon one's inherent faculty and one's knowledge and awareness of the use of income. The knowledge of the possible uses of extra income can be imparted to every one. The inherent faculty to enjoy income, however, is not dependent upon the level of income one is having.

Another argument in favour of proportional tax schedule is its administrative simplicity. It is claimed that proportional taxation is easily decided and enforced, especially because complicated rate schedules and a degree of progression in each tax is not to be worked out. As we have seen above, this argument is untenable when its sacrificial dimension is looked at. From that point of view, a proportional tax is really regressive and oppressive and this fact should not be forgotten. In terms of fixing the rate schedules, of course, proportional taxes are quite convenient and simple. But to say that they would be simple enough administratively also is not true. Actually in the case of proportional taxes, the points at which tax collection is to take place become too numerous and administratively unmanageable. For example, a proportional income tax would involve taxing every individual, family in the society irrespective of the income level. This would involve a herculean task of estimating the net income of too many tax-payers in the country and collecting the tax also. Such a tax on longer remains 'simple' in the true sense of the term. It no longer remains 'economical' also. The cost of collection can be very high compared with the tax proceeds.

It is claimed that a proportional tax does not change the relative position of different tax-payers. They all lose the same proportion of their purchasing power and therefore a proportional tax is 'neutral' in terms of the allocation of resources of the economy to different uses. To put it differently, a proportional tax does not affect the relative demand/supply positions and therefore the developmental course of the economy. This type of reasoning is quite misleading. *Firstly*, it must be remembered that when the income of a tax-payer is reduced he adjusts his demand pattern for various goods and

services. A richer person would tend to maintain his consumption standard by reducing his saving and therefore the consequent supply of investment funds and the demand for capital goods would fall. This, in itself, would retard the rate of economic growth though the State action may more than compensate the deficiency here. The poorer sections, on the other hand, will have to reduce their consumption itself and this may not be desirable from the point of view of their health and efficiency. Actually a progressive tax would appear to be far more acceptable on these grounds. It would divert potential savings of the rich into State hands and the State can use them for accelerating economic growth. It would at the same time permit the poorer sections to maintain their consumption standards.

Arguments For and Against Progressive Taxation

A very strong case for progressive tax rates exists in terms of ability-to-pay and the corresponding sacrifice which taxation involves. This argument, of course, is based upon the assumption that marginal utility of income is subject to a reduction as income rises. For believing in this possibility and corresponding policy prescription of progressive rates we do not have to believe in the measurability of utility or the possibility of interpersonal comparisons. Such a possibility, if it existed, would additionally enable us to construct precise schedule of tax rates conforming to the dictum that marginal disutility of tax to each citizen should be the same and that the aggregate sacrifice involved should be the least. However, the degree of inequalities of income and wealth are so large that we are not likely to go wrong even with a high degree of progression and a scope for reducing the aggregate sacrifice would still remain.

Lerner, in his book *Economics of Control*, demonstrates that even in the absence of known marginal income utility schedules, so long as we can assume that the marginal utilities would be different, a movement towards equality of income would increase the total utility of income to the society. He further argues that in case the individual members of the society do not have equal capacity to enjoy income, we should still move towards equality, though at a slow rate. Therefore, the arguments of those who reject progressive tax rates on the basis of non-measurability of utility stand rejected. The only concession that could be give· to the opponents of progressive rates is that in the short run progression may be within limits and only over time the degree of progression should be increased at a gradual rate. Seligman, however, persists in his belief that different individuals have unequal capacity to enjoy income and therefore rejects a degree of

progression that would bring about complete income equality. He says: "Legal justice means legal equality, and a legal equality which attempts to force an equality of fortune in the face of inevitable inequalities of native ability would be a travesty of justice."[3] But the problem is that market forces create inequalities which are clearly far in excess of the possible differences in the capacity to enjoy income and as Adolph Wagner puts it, a tax system is a powerful instrument for correcting the distribution of income and wealth as determined by the market forces and the institution of inheritance.[4]

It is found, further, that progression can be advocated on the basis of social justice also which manifests itself in the form of taxing the people according to their ability to pay. Since progressive tax schedules try to bring about equal marginal sacrifice on the part of the tax-payers and since through that approach the whole tax system moves towards the least aggregate sacrifice, such a tax system is just as between individual tax-payers and for the society as a whole also.

It is, however, to be noted that the case for progressive tax has been disputed on the grounds of not only non-measurability of utility and the impossibility of interpersonal comparisons of utility, but also on the grounds that a progressive tax should be adopted only when marginal utility of income falls faster than the rise in income. Actually, the very objective of imposing equal sacrifice through taxes is contested. It is asserted accordingly that the case for progressive taxation is quite weak.[5]

Benefits-received principle does not necessarily imply a progressive tax rate especially when we consider the welfare activities of the government. This approach would direct the government to tax the poor people more on account of the benefits received from its welfare activities. Even if we ignore the welfare activities of the State, it is debatable whether it is the rich or the poor who derive this benefit more. We have seen these arguments in detail while discussing the benefits-received approach and found that depending upon our opinion we could end up advocating progressive or regressive taxation.

The degree of progression of the tax rates has an important bearing upon the process of saving and capital accumulation in an economy. Here the opponents of progression will claim that it is only the rich that can save and therefore if they are taxed more heavily than the

[3] E.R.A., Seligman, *Progressive Taxation in Theory and Practice*, 1908, p. 131.

[4] Adolph Wagner, *Finanzwissenchaft*, 1890, pp. 381-5.

[5] *See* Walter J. Blum and Henry Kalven, Jr., *The Uneasys Case for Progressive Taxation*, University of Chicago Press, 1953, pp. 43-45.

poor, the saving potential will be lost or reduced. However, the argument in favour of progressive taxation would be that it is only the rich from whose incomes savings can come. Accordingly, why should not those potential savings be taxed?

Firstly, if the State does not tax the rich more heavily they are also likely to increase their consumption of luxuries and thus use up the productive resources of the society wastefully. In order that the rich should be prevented from this, they should be taxed more heavily.

Secondly, in the absence of progressive taxation the richer will become still richer and inequalities would increase. This tendency will accentuate the process of mal-allocation of the resources of the economy in favour of luxuries at the cost of necessities. It will also lead to a concentration of economic power in the hands of the richer sections which would be tempted to misuse them.

Thirdly, proportional taxation would endanger the health and productivity of the masses. It may also cause various forms of social and political unrest.

It is, therefore, asserted by the supporters of progression that the State should tax the richer sections more heavily to ward off the possible ill-effects in terms of social and political unrest, weak health and low productivity of the masses and misuse of the nation's productive resources. Further, the State should take an active part in the economic growth of the society through its budgetary savings, promotion of the public sector, provision of social overheads, and so on.

In a modern free enterprise exchange economy, progressive taxation has an additional advantage of acting as a built-in stabilizer. That is, the tax system acts as a cushion against an excessive upward or downward movement in income and prices. Since the poor are taxed less heavily, and since the poor have a high marginal propensity to consume, it provides a firm base for a minimum effective demand in the country. As income increases, it is higher incomes which are taxed more, and during a depression, the higher income earners get larger tax relief. Thus, the economy gets a firm demand base even in a depression and its extra purchasing power is taxed away during a boom period. The tax bill varies in line with the upward or downward movement of the economy.

In a poor, underdeveloped country, unfortunately, this policy prescription of raising resources through budgetary savings may necessitate the use of regressive taxes. A poor country, by definition, does not have an adequate economic surplus which would be saved on its own. Such savings have to be forced upon the society to a great extent. And this leads the State to impose a variety of indirect taxes

such as excise duties, sales taxes etc. In order to raise adequate revenue, these indirect taxes have to touch articles of mass consumption and are not to be confined only to items of luxury patronized by the rich. Indian tax system illustrates this tendency where indirect taxes are increasing much faster than direct ones.

It must be remembered, however, that an emphasis on indirect taxes becomes necessary only when direct taxes (which would be generally progressive) fail to yield adequate revenue to the State. In an underdeveloped economy, the welfare and growth requirements compel the State to raise more revenue which it can only through relying more and more upon indirect taxes of the regressive type. Unfortunately, therefore, the theory of progressive rates cannot be fully put into practice in underdeveloped economies.

The degree of progression in taxation is also intimately connected with the will to work and save. The opponents of progressive taxation argue that economic progress cannot be ensured unless people work for it and for hard work they must have adequate economic incentives. In other words, the argument maintains that unless people are able to enjoy the fruits of their labour, they would not work more and productivity in general would decline. The richer people will save less and there will be a retardation in the process of capital accumulation. This type of logic tends to mislead us. *Firstly*, as far as saving and investment are concerned, we have seen above that the State can perform these functions provided it wants to and provided it has an adequate and efficient administrative machinery for it. What is, therefore, needed for this aspect of the problem is an effective and proper system of economic incentives for efficiency and punishment for inefficiency in the public sector of the economy. Regarding incentives for hardwork, why should we assume that it is only the rich which need this incentive? The poor need it in a far greater measure. Actually it may be stated that the rich will rather opt for more leisure beyond a certain level of income in order to enjoy that income. The poor, on the other hand, will not only be edged on to harder work if they find the existence of appropriate economic incentives, but would also find their productivity increasing through greater consumption (on account of larger income availability).

One further point in favour of progressiveness is its administrative convenience. In the case of proportional taxation, or regressive taxation, tax collecting machinery has to cast its net very wide. This not only causes undue harassment to small tax-payers, it also leads to a high cost of tax collection. In the case of progressive rates (and steeper the progression, the better for it), the cost of tax administration and

collection would be proportionately much lower.

DIRECT VS INDIRECT TAXES

The distinction between direct and indirect taxes is not always a satisfactory or a consistent one. There has been a long tradition in economic literature to classify taxes into these two categories. One way of distinguishing between these two has been in terms of the incidence of taxation. It is asserted that if the incidence of a tax rests upon the person who bears its impact also, then it is a direct tax. If on the other hand, the incidence is passed on to others, then it is an indirect tax.[6] J.S. Mill, the Physiocrats and others believed in this kind of distinction. However, it is obvious that such a distinction is not easy to maintain, especially because in some cases the incidence of the tax may shift partly and in some cases fully or even more than fully. Again, the shifting of incidence may differ even in the case of the same tax over time and so on. Because of these complications, some authors tend to discard this distinction. For example, Taylor says, "The terms "direct" and "indirect" tax. . .are finally distinguishable in meaning only in terms of shiftability. Direct taxes are not shifted, while indirect types are. The decline in the use of these terms can be accounted for by inability to make such broad generalization with respect to many tax measures."[7]

However, the distinction between direct and indirect taxes on the basis of the coincidence of impact and incidence is not the only one available. In economic literature we also come across many other bases of this distinction. For example, it has been maintained that while taxes on production are direct, those on consumption are indirect. Similarly, it has also been claimed that taxes on income are direct but those on expenditure are indirect. It would be noted that these types of distinctions do not have a sound economic basis. For example, why should we term taxes on production direct while those on consumption indirect? Both are two important activities in the economy and one cannot be sustained without the other. Similarly, to distinguish between taxes on income and taxes on expenditure would be equally faulty and more so when we notice that in terms of flow of funds in the economy, receipts and expenses are two dimensions of the same activities. If we want to have an economic basis for

[6] J.S. Mill, *Principles of Political Economy*, Ashley Edition, 1909, p. 823.

[7] Philip E. Taylor, *The Economics of Public Finance*, 3rd edn., 1968, p. 307, footnote 1.

distinction between direct and indirect taxes, then the plausible approach would be to maintain that in the case of direct taxes the liability is determined with direct reference to the tax paying ability of the tax-payer, while in the case of indirect taxes such an ability is assessed indirectly. For example, income tax is a direct tax. Here the tax paying ability is assessed directly in relation to the income of the assessee assuming that such an income is a true indicator of his tax paying ability also.

Same is the case with gift tax, inheritance tax, expenditure tax, wealth tax, and so on. All these are examples of direct taxes. Corporation taxes, such as taxes on profits, sales proceeds or assets of firms and corporations are also considered direct taxes because these institutions are also considered economic entities. An excise duty, on the other hand, is an indirect tax. For example if each piece of radio is taxed at a rate of say 20 per cent of its value, then it is assumed that a person who purchases a radio will have this capacity to pay the tax, and one who purchases a costlier radio will have a greater ability to pay. It is partly on this reasoning that costlier items and luxuries are usually subjected to higher sales taxes and/or excise duties while articles of daily necessities are generally exempted or are taxed lightly. Apart from excise duties and sales taxes, import and export duties, taxes on rail and bus fares and so on are also in the category of indirect taxes.

Indirect taxes may be specific or ad valorem. When they are imposed on 'per item' or 'per unit' basis, they are called specific. On the other hand, when the tax amount is scheduled according to the value of the item being taxed, it is ad valorem. Excise duties, for example, are generally specific. Sales taxes are mostly ad valorem. Taxes on rail and bus passenger fares are usually ad valorem, but they can be specific also. The advantage in having ad valorem taxes is that the tax automatically gets hinged on to the value of the item and would move along with its value. For example, if there was a tax on rail fares on a specific basis, each passenger fare would be taxed equally. Since most rail passengers travel only a short distance, the tax per passenger will have to be very low. A very long distance passenger would also pay the same low tax. An ad valorem tax, say 10 per cent, on the other hand, would ensure that a passenger paying Rs 2 as rail fare pays only 20 paise as tax, while the passenger paying Rs 200 either due to a long distance or due to a higher-class travel pays Rs 20 as tax. The yield from ad valorem tax is more flexible and its incidence is more just.

This brings us to the question of merits and demerits of direct and

indirect taxes a knowledge of which helps the government in choosing a judicious combination of both types. We are not likely to come across an economy where only one form of taxation is being used to the exclusion of the other. What would differ from one economy to the other is the exact proportion in which these taxes are mixed.

Merits and Demerits of Direct Taxes

It is claimed that direct taxes are intimately related to the ability-to-pay. In their case the ability-to-pay is judged directly and not indirectly as in the case of indirect taxes. Accordingly, there are lesser chances of making an error of judgment. Direct taxes can be chosen and their rate-schedules determined in such a way as to secure the maximum possible closeness to the ability to pay and the least aggregate sacrifice. In these taxes, we can determine the degree of progression that we want and thus bring about adequate social and economic justice. These taxes can be used for reducing income and wealth inequalities and thereby various social evils can be mitigated. We must, however, remember that these arguments are quite sound provided in practice a proper degree of progression of tax schedules can be chosen. Usually what happens is that authorities are either too hesitant to adopt a fair degree of progression and therefore direct taxes fail to contribute appreciably to the reduction in income and wealth inequalities, or they become extra enthusiastic in their zeal to bring about equalities. In the latter case, their policy tends to reduce the generation of national income and therefore leads to an all round reduction in enonomic welfare. These two are real dangers of using direct taxes for achieving a degree of income and wealth equality, but this demerit is not an inherent feature of direct taxes. It is a possibility that exists and that can be avoided.

The opponents of direct taxes would claim that since a precise degree of needed progression cannot be estimated (on account of the difficulties of measuring the ability to pay and the subjective nature of the marginal utility of income), the State would always end up with either too much or too little progression. This argument, however, cannot be used to banish the use of the direct taxes as such. *Firstly*, the need for direct taxes is to be recognized in terms of their ability to have progression. *Secondly*, indirect taxes are generally regressive and discarding the direct taxes would entail a far greater movement away from the principle of ability-to-pay.

It should be noted that no one direct tax may be taken as a measure of ability to pay. A combination of different indices like income, wealth, expenditure, gifts, inheritance, capital gains, windfalls etc.

would be needed and that is why not one but a number of direct taxes should be used in a harmonious way so as to reach closest to the appropriate and true measure of ability-to-pay.

It is claimed that direct taxes do not cause at all (or cause very little) distortion in the resource allocation of the economy and that they leave the tax-payers better off than do the indirect taxes. This way, on welfare grounds, the superiority of direct taxes is sought to be established. We shall elaborate this point under the heading "Are Direct Taxes Less Burdensome?" of this chapter and we shall see that this assertion is based upon two highly unrealistic assumptions. Here, however, mention may be made of the Colwyn Committee Report of 1927 in which it was argued that income taxes do not affect relative prices or production of goods and services. The Committee argued that a general income tax would leave the relative profitability of different industries unaltered and would not have any effect on resource allocation. Moreover, in every firm, the marginal cost would equal price which implies that the marginal unit of output does not yield any profit and is not subject to any tax. Hence, taxation of income would not affect output also. The irrelevance of this reasoning can be easily seen. We do not have perfect markets; and the contention that market price and marginal cost of production are equated stands sufficiently discredited in favour of other hypotheses.

Revenue elasticity is another point put forth in favour of direct taxes. In other words, as income of the community goes up, so does the tax yield from direct taxes. This is a claim which can be made for indirect taxes also, and such a claim need not be true for some direct taxes. When the general level of activity and income goes up in the economy, there is likely to be a corresponding increase in sales/purchase and other activities. It is not that income and employment can increase in vacuum. Accordingly, it is not only direct, but indirect taxes also which should be expected to increase. Also it should be noted that the authorities would not be interested only in the tax revenue as such, but also in the social and economic justice through the tax instrument. From that point of view, of course, direct taxes are often preferable.

The advocates of direct taxes assert that these taxes inculcate a spirit of civic responsibility amongst the tax-payers. They then try to be more vigilant about how much tax revenue is being raised and to what uses it is being put. This argument, it appears, is quite misleading. *Firstly*, this argument contradicts another one according to which direct taxes leave the tax-payers better off than do the indirect

taxes. If this isthe case, then obviously people will be less conscious of the taxes when they are being paid directly. *Secondly,* with this awareness of their tax liability, they would try to evade the taxes. And the practice and possibility of tax evasion and avoidance is more here than in the case of indirect taxes where the tax-payers often get the impression that they will be able to pass on their incidence.

Amongst the demerits of direct taxes we may add the fact that they generally violate the canon of convenience. Indirect taxes are usually paid in instalments for each transaction and so on. They can also be avoided to some extent by shifting one's expenditure pattern or reducing the total expenditure. Direct taxes, on the other hand, are generally payable in lump sum or even in advance and become quite inconvenient.

Another demerit of direct taxes is their supposed effect on the will to work and save. It is asserted that work (giving income) and leisure are two alternatives before any tax-payer. If, therefore, a tax is imposed, say on income, the tax-payer will find that the return from work has decreased as compared with return from leisure. He, therefore, tries to substitute leisure for work. Harberger, however, comes to the conclusion that no a priori case in favour of direct taxation can be established since both direct and indirect taxes affect the choice between work and leisure[8]. There is, therefore, a reduction in the will to work on the part of the tax-payers and this tendency is bad for the economy since it leads to an all-round slowing down of economic growth. Similarly, if the authorities tax property and inheritance etc., it will cause a reduction in the will to save. Capital accumulation in the economy will suffer and there will be again a retardation of economic growth.[9] This happens because the tax-payer then starts comparing the utility from current consumption with the utility from future income (which he shall earn through income from savings). The tax-payer may even compare the utility from current consumption with the satisfaction which he derives from handing over a certain amount of gifts or inheritance to the beneficiaries, children etc. Since the taxation reduces the utility going to the beneficiaries, the tax-payer tends to consume more

[8]Arnold C. Harberger, "Taxation, Resource Allocation, and welfare," *The Role of Direct and Indirect Taxes in Federal Revenue System*, Princeton, 1964, pp. 25-81.

[9]Harberger, for example, shows that an income tax reduces the rate of investment more than a consumption tax of equal yield would. See Harberger, *op. cit.*, pp. 58-62.

himself and save less for heirs.

This possible disadvantage, however, may be counteracted by two other forces:

Firstly, a tax-payer may be seriously interested in leaving at least a certain amount of net inheritance or a net gift to the beneficiary in which case he would try to save more to compensate for the tax payment.

Secondly, it is also possible that the expected income from investing the saving may be so much that even such direct taxes do not have a significant effect upon saving and investment activities. These counter-acting forces, however, are not likely to be general and strong. It may be stated quite strongly that direct taxes are very likely to discourage saving and investment activities (though these tendencies may be counterbalanced by other fiscal policies or other socio economic forces).

Merits and Demerits of Indirect Taxes

An important merit of indirect taxes is that they are less inconvenient, and from that point of view less burdensome (their being less burdensome from other points of view is not agreed in general). The tax-payers pay these taxes in bits and generally when they enter into some transactions of sales and purchases. Furthermore, indirect taxes are usually hidden in the prices of goods and services being transacted and, therefore, their presence is not felt so much.

Another merit of indirect taxes is that with proper administration, the chances of tax evasion in their case are less. Excise duties, for example are quite difficult to evade if the government machinery is vigilant and there is a proper check at the points of production. Sales tax, however, is more difficult to administer especially if we allow various exemptions either to goods and services or to sellers having turnover of less than a certain amount. Furthermore, the points of sales tax, are larger in number and spread over wider areas. It is for this reason that in some cases, additional excise duties are imposed in lieu of sales taxes. But there are other indirect taxes which are not that difficult to collect, for example, taxes on railway and bus fares. Here the points of collection are manageable in number and accounts of the transactions are usually well maintained. All told, indirect taxes are subject to far less evasion than direct ones.

In an underdeveloped country, indirect taxes have a special role to play. Such a country is in need of additional saving and capital accumulation. Total national income being low, the scope to squeeze adequate tax revenue both for running the administration and for bringing about capital accumulation is very limited. Furthermore, in such an

economy, there is usually an urgent need for providing certain basic amenities and welfare activities such as drinking water, health services, protection against malnutrition, and so on. Given this enormous need for tax revenue, and given the limited scope of direct taxes, indirect taxes have to play a crucial role in such economies. The only exceptions to this rule can be those economies which have some huge export potentialities such as oil and the export of which would enable the authorities to finance their welfare and growth activities.

Another merit of indirect taxes is that they are a powerful tool in moulding the production and investment activities of the economy, i.e., they can guide the economy in its resource allocation. It is generally recognized that market mechanism by itself is not a perfect institution for the economy. It has many defects which manifest themselves in the form of not only inequalities of income and wealth, but also in the distorted patterns of consumption, production and employment. Direct taxes can be used as corrective tools in this connection. A proper structuring of indirect taxes can enable the authorities to twist the demand and supply forces in a way so as to yield desirable results—encouraging higher priority industries and discouraging lower priority ones. For example, an imposition of a high rate of excise duty or a sales tax will raise the price of the goods and discourage its demand. Reduced profitability of this item will, therefore, lead to drying up of investment in this line and diverting it to those lines where profitability is comparatively higher. Similarly, indirect taxes can also be oriented towards increasing emloyment or encouraging the adoption of particular technology. For example, an extra duty upon mill-made cloth, while exempting the handloom cloth from the same will act as a booster for handloom cloth and will encourage employment also. If, on the other hand, the intention is to encourage capital-intensive techniques, labour intensive outputs can be taxed more heavily. Similar logic applies to various situations and policies with regard to customs duties. The main point to be emphasized is that indirect taxes can be highly selective both commodity-wise and rate-wise and thus can be designed as a powerful tool for guiding the economy.

Another advantage of indirect taxes, which makes them a versatile and selective policy tool is their flexibility. Direct taxes cannot be very selective and therefore are not so flexible, while indirect taxes are. The rates of indirect taxes and their coverage can be quite selective and can be modified more readily to suit the occasion. This is often practised also in the case of customs duties.

Arguments against indirect taxes are only a few but powerful ones. *Firstly*, it is claimed and very rightly that these taxes negate the prin-

ciple of ability-to-pay and are therefore unjust to the poor. By their very nature (since one of the objectives is to collect enough of revenue), they are spread over to cover the items which are purchased generally by the poor. This makes them regressive in effect. For this reason, indirect taxes also militate against the objective of least aggregate sacrifice. This ill-effect of indirect taxes is sought to be corrected by heavily taxing the luxury items. However, such a correction can only be partial and no more than that. Taxing the luxuries alone will not yield adequate revenue for the State.

Another defect of indirect taxes is that they feed inflationary forces. Direct taxes take away a part of the purchasing power of the tax-payer and that has the effect of reducing demand and prices. On the other hand, indirect taxes begin with adding to the sale prices of the taxed goods without touching the purchasing power in the first place. The result is that in their case inflationary forces are fed through higher prices, higher costs, and wages and again higher prices.

Are Direct Taxes Less Burdensome?

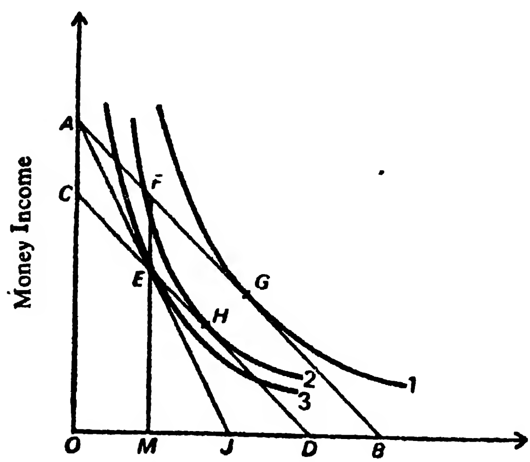
In economic literature, there has been a good deal of discussion as to which form of taxation is more burdensome for the tax-payers. This discussion is obviously based on the assumption that we are to compare alternative ways of raising the same tax revenue. It is further assumed that the public expenditure policy remains unaffected by the form of taxation, so that the superiority or otherwise of a tax does not lie in the *amount* of resources transferred from the private to public sector, but only in the effects which different methods of such resource transfer entail. We have already discussed the merits and demerits of both direct and indirect taxes. Here therefore the question of burden of the alternative forms of taxation may be viewed from the point of view of (*a*) a possible shift in resource allocation, and (*b*) a sacrifice on the part of the tax-payers. It is usual to provide this comparison by representing direct taxation by a proportional income tax and representing indirect taxation by a proportionate tax on commodities.

The dimension of resource allocation has been discussed in the chapter effects of taxation. It is shown there that an indirect tax is expected to cause a shift in the relative prices of goods and therefore bring about a resource allocation which would be different from the allocation achieved by free market mechanism. An income tax, on the other hand, is expected to let the relative prices remain unchanged and therefore be neutral regarding resource allocation. If we assume that the resource allocation in the absence of any tax is already

optimum, then an indirect tax would cause a distortion in it and would be burdensome to the economy to that extent. On the other hand, if the initial resource allocation is not optimum, then indirect taxation becomes an effective instrument in bringing it nearer optimum.

Miss Joseph, Hicks and others have maintained the superiority of direct taxes over indirect ones by showing that the tax-payers have to undergo lesser amount of sacrifice in satisfaction in the case of direct taxes. On welfare grounds, therefore, direct taxes are supposed to be superior.[10]

This is illustrated with the help of indifference curves technique (Fig. 8.1). Let us take the case of a single consumer who is to be taxed by the authorities. Let his money income be measured along *Y*-axis and let *X*-axis represent goods in general. Let his money income be *OA* which can purchase *OB* amount of goods. Then *AB* is the budget line and his equilibrium position is given by point *G*. The consumer is on indifference curve 1. Now let the authorities impose a proportionate tax on all goods so that the new budget line becomes *AJ* giving the consumer's equilibrium position at point *E* and pushing him to indifference curve 3. If, however, the authorities raise the same tax revenue by means of an income tax, then the new budget line will be *CD* (it will pass through point *E* and will be parallel to *AB*). *CD* still lies below *AJ* before the point *E* and above *AJ* after the point *E*. As a result the consumer will attain his new equilibrium position at point *H* which is on a higher indifference curve, namely number 2. (It will also be seen that through indirect taxation, the government was getting a tax revenue equal to *EF*= *AC*.)



Quantity of Goods in General

FIG. 8.1

This treatment showing the superiority of direct tax over indirect taxes is, however, not free from defects.

[10]M.F.W. Joseph, "The Excess Burden of Indirect Taxation," *Review of Economic Studies*, June 1939, Figure II, p. 227. Also J.R. Hicks, *Value and Capital*, p.41.

D. Walker points out some such defects.[11] *Firstly*, this analysis assumes that the tax-payer's indifference map does not alter in view of changing tax rates and their forms. This is highly unrealistic since the tax-payers are most sensitive to both the form and rates of taxes. For example, their dislike for direct taxes may be more than their dislike for indirect taxes because direct taxes are more open. Accordingly, even if theoretically, the consumers are able to reach a higher indifference curve through direct taxes, they may not want to be taxed directly. D. Walker puts it by saying that in such a situation it is not necessary that the higher indifference curve is a preferable situation. In the same manner, the tax rates and the division of taxes between direct and indirect ones is bound to affect the relative preferences of the consumers as between one good and the other and as between money income and goods. To assume in the traditional way that no change in indifference curves would take place on account of different tax rates would amount to saying that the elasticity of demand for goods is zero in each case. This is certainly not true.

Still another defect of this approach is that it starts from a position of no-tax and tries to analyze the best way in which a given amount of tax revenue could be raised. In practice, however, every economy has some taxes, both direct and indirect and what is to be decided is a change in their composition and rates. The net effects will differ according to the position from where we are starting. Given these defects, therefore, D. Walker asserts that "broadly speaking, then, the Joseph-Hicks theoretical demonstration of the superiority on welfare grounds of direct or indirect taxation is only a satisfactory proof on the twin assumption of a completely inelastic supply of labour with respect to income and outlay taxes and 'ideal initial conditions'."[12] The term 'ideal initial conditions', we should note, refers to a position of no taxes in existence.

The comparison between direct and indirect taxes as outlined above implicitly assumes that the resource allocation as brought about by the market demand and supply forces is an ideal one. This assumption can be challenged. Actually, as we shall have occasion to see time and again, an important reason for an effective government intervention in the market is the 'defective' working of the latter. Briefly speaking, we may put forth two arguments here. The first one relates

[11]D. Walker, 'The Direct-Indirect Tax Problem: Fifteen Years of Controversy," *Public Finance*, Volume 10, 1955, pp. 153-77, reprinted in R. W. Houghton (Ed.), *Public Finance*, Penguin, Second edn., pp. 417-43.

[12]D. Walker, *op.cit.*, reprinted in Houghton, *op. cit.*, p. 423.

to the popular assumption of perfectly competitive market. It is now realized that such a market is merely a myth. In reality a large number of market imperfections are in operation which bring about a defective allocation and utilization of productive resources. Left to the market forces, an economy may not be able to correct regional imbalances, emergence of monopolistic elements and the like. As a result, very often, the economy may not be able to generate the requisite rate of savings and capital accumulation. The second argument relates to income distribution. In a pure market economy, income distribution as between different members of the society is not based upon their relative needs, but is determined by the pricing and ownership of the factors of production. This system creates and perpetuates income inequalities. The institutions of private property and inheritance widen the income and wealth inequalities with the passage of time. Thus we build up the sequence of reasoning like the following: income and wealth distribution in the society are not in harmony with the relative needs of the members of the society. The demand pattern which emanates from such an income and wealth distribution fails to reflect the true needs of the society and hence the production pattern and resource allocation of the economy cannot be considered the optimum ones. There would be a divergence between private costs and benefits from social costs and benefits. There may, therefore, be a need to bring about a shift in such an allocation through tax measures. If so, indirect taxes of specific type may be preferable to direct taxes.

It may also be noted that we should not confine ourselves to a comparison between proportional direct income tax with proportional indirect taxation of all goods. A good deal of possibilities exist regarding the exact coverage and rates of both direct and indirect taxes and it is not logical to compartmentalize the comparison between two specific varieties of direct and indirect tax systems only.

Milton Friedman challenged this Joseph-Hicksa pproach by pointing out that this treatment related to a single tax-payer. It did not apply to the whole community of tax-payers because this approach was ignoring the expenditure side of the budget and the production possibilities in the economy.[13]

One particular argument in favour of direct taxes, however, would be that in order to make sure that each tax-payer was paying according to his ability-to-pay (in whatever way it is defined), it will be administratively and otherwise easier to collect the taxes directly.

[13]Milton Friedman, "The Welfare Effects of an Income Tax and an Excise Tax," *Journal of Political Economy*, February 1952, pp. 25-33.

Imposing indirect taxes cannot ensure the desired relative distribution of tax burden as between different tax-payers.

VALUEADDED TAX

Value-added tax (VAT) belongs to the family of sales taxes. Therefore, it would be helpful if we briefly distinguish between these different forms of sales taxes and note the place of VAT in them. A *general sales tax* is a tax on sales transactions but it is applied at only *one* stage of business activity. We know that a production process has many stages right from the manufacturer to the retailer before the good finally reaches the consumer. A general sales tax may be applied at any one of these stages. Usually, however, it is collected either at the wholesale level or at retail level. The traders are allotted sales tax numbers and a trader possessing such a number can purchase the goods without paying the sales tax. He similarly would sell the goods to the next buyer net of sales tax if the next buyer also happens to possess a sales tax number. Otherwise he charges the sales tax on his sales and deposits the proceeds with the authorities. Compared to a general sales tax is the *turnover tax*. While a sales tax is imposed only at one point of sale, a turnover tax is imposed at each sales transaction. One good, therefore, will be subjected to as many tax levies as there are the transactions through which it passes. A turnover tax accordingly tends to increase the final sale value to the consumer cumulatively. In order to secure competitive advantage over others, the firms try to go in for vertical integration and thus avoid turnover taxes on intermediate sales. This encourages monopolistic tendencies.

VAT is a tax not on the total value of the good being sold, but only on the value added to it by the last seller. The seller, therefore, is liable to pay a tax not on its gross value, but net value, that is the gross value minus the value of the materials purchased from other firms etc. The basic difference between VAT and a sales tax is that the tax liability under VAT is split up into stages. Theoretically, the tax liability in the case of VAT and in the case of sales tax at the retail level should turn out to be the same. This is because the total retail price is nothing but the value added to the raw materials at different stages of 'production' and trade. In the case of VAT, the same total created value is taxed in stages. The usual practice is to estimate the tax liability of the last seller on the basis of gross value of the produce and give him credit for the taxes paid by the earlier sellers. It must be noted that here the assumption is that final sale

value at retail level represents the actual value added at different stages and that the market friction and other imperfections are not distorting the whole picture. "The differential incidence of the retail sales tax and the value added tax, consumption type, is nil, because both taxes have the same aggregate base. The consumption tax (retail sales tax) is imposed on the amount consumers pay (*ex* other tax, if any) for consumption goods, and the value-added tax, consumption type, is imposed on the amount paid to factors for producing those goods. These remarks, of course, abstract from friction and the imperfections in the market."[14] But a basic difference between a sales tax and VAT which must be emphasized is that the base of VAT "is not the gross value of the retail sale but rather the *net* value added at each stage of production."[15] And that distinguishes it from a turnover tax also where each transaction is taxed on its gross value.

VAT was adopted through historical evolution by France in 1954 and since 1967 countries of European Economic Community (EEC) also decided to adopt VAT and a few other European Countries also followed suit including UK in April 1973. However, Japan, having adopted this system in late forties soon abandoned it. It is being used in some underdeveloped countries also.

Forms of VAT

Like a sales tax, VAT can also be designed to have different forms, exemptions and rates. In this connection, there are two important varieties of VAT, viz. the Consumption Variety and the Income Variety. The difference between these two varieties emerges from the *treatment of capital depreciation*. If a firm is allowed to deduct the entire credit when the capital equipment is purchased, the system is termed as *consumption VAT*. If the firm is allowed to deduct the credit as the equipment *depreciates* over time, the system is termed as an *income VAT*.[16]

Carl S. Shoup, however, distinguishes between four possible varieties of VAT:

(1) In this case to arrive at the value added by a firm, the value of the inputs purchased by it from other firms is not deducted in full. Only the value of non-capital purchases is deducted. Furthermore, no depreciation is permitted on the purchase of capital goods even in subsequent years. Thus, the value added by a firm is taken to be inclu-

[14]Carl S. Shoup, *Public Finance*, Weidenfeld and Nicolson, 1969, p. 425.
[15]John C. Winfrey, *Public Finance*, Harper and Row, 1973, p. 426.
[16]*Ibid.*

sive of the use of capital goods even when they have been purchased from other firms. For the economy as a whole, the value added, calculated in this way, becomes equal to the gross national product (if there is no foreign trade). Therefore, the aggregate base for the value added tax for the country as a whole also becomes the Gross National Product (GNP). This variety may be termed *production VAT.* In simple words, the tax base for any firm will be just sales minus materials (other than capital-goods). This type of VAT obviously cannot be popular with the governments, because it militates against the use of capital and retards economic growth

(2) The second variety is of *consumption VAT.* In this case, the firm in question is allowed to deduct from the gross value of its product not only the non-capital inputs purchased from other firms, but also the capital equipment so purchased. In the absence of foreign trade, the aggregate base of this tax for the economy as a whole becomes Wages (W) plus Profits (P) plus Depreciation (D) minus Investment (T). Now since GNP is equal to $W+P+D=$ Consumption (C)+Investment (I), therefore, the aggregate tax base becomes GNP—I, that is, *consumption* in the economy. All the European countries which have adopted VAT have chosen the consumption variety. One reason for this is that if the firms are allowed depreciation on capital equipment, they tend to apply a high rate of depreciation. "The definition of value added net of all fixed capital purchases instead of net of depreciation is, of course, illogical but deliberate. It aims at correcting the biases against faster scrapping and mechanization. . . ."[17] Also such a tax base is simple to estimate. Winfrey uses a simple way of presenting this variety of VAT, namely 'sales proceeds minus capital minus materials.'

(3) The third variety is the one where the firm is able to deduct the net earnings from its capital in order to arrive at the tax base. Since earnings from capital amount to profits plus interest, therefore, the balance left to be taxed is equivalent to wages. This variety of VAT is, therefore, called the *wage-type VAT.* This variety is also unlikely to be used for taxation by any government.

(4) The fourth variety is where the firm is allowed to deduct the full value of its non-capital purchases from other firms and a depreciation on the capital-purchases from other firms. This approach obviously gives us the proper net value added. For the country as a whole the aggregate tax base (in the absence of international trade)

[17]D.K. Stout, "Value Added Taxation, Exporting and Growth," *British Tax Review*, September-October, 1963, in Houghton, *op. cit.*, p. 481.

would be the *net national product* (NNP). This is called the *income-type* VAT. In other words, here the tax base is sales minus materials minus depreciation for each firm. The income variety is the most complicated of all the varieties though logically it has a greater appeal.

This brings us to the merits and demerits of VAT.

Merits of VAT

(1) A general VAT is supposed to be neutral to the forms of production and commercialization. In the case of a turnover tax, for example, at each sales transaction a tax is added. As a result a turnover tax encourages vertical integration of production so as to avoid the intermediary sales and taxes and also to acquire a competitive advantage over others. For example, a bicycle factory which is manufacturing its own steel pipes and rims etc., would pay a smaller turnover tax than another which has to purchase these materials from other firms. A VAT, on the other hand, is neutral between these processes of integration and therefore helps the economy in adopting those forms of production which are economically more suitable.

(2) A very important advantage quoted in favour of VAT is that of lesser tax evasion. *Firstly*, this happens because the tax is divided into parts and therefore the incentive to evade tax by any one firm is reduced. *Secondly*, it is in the interest of a firm to account for the taxes paid by earlier firms through which the inputs have come—otherwise this firm pays the tax itself. If any firm, therefore, understates its output, it will be caught by the disclosures of the firms buying inputs from this firm. This type of cross-auditing enables the authorities to plug the tax leakages.

(3) The use of VAT helps a country in encouraging its exports. In order to get a competitive edge over others, a country may refund the taxes paid on the exportable goods. It is easy to separate the tax from the cost of production in the case of VAT, but not so in the case of other taxes which get mixed up with the cost of production (since they are levied at gross value in each case). The other advantage is that the General Agreement on Trade and Tariffs also recognizes VAT rebate as a legitimate practice of encouraging exports.

(4) It is also claimed that VAT is conducive to efficiency since a firm is not exempted from its tax liability even if it runs into a loss. It pays a tax not on its profits but on the value produced. It, therefore, tries to improve its performance, and reduce the cost of production.

Demerits of VAT

VAT, however, is not just a bundle of advantages. Rather it has serious limitations especially for underdeveloped countries because of which it has not yet become popular.

(1) VAT is not an easy system to adopt, especially in an underdeveloped country. It is a complicated system and needs an honest and efficient government machinery to do the cross checking and link up various production activities and the resulting tax liability of each firm. It is, therefore, necessary that the country adopting it should also be sufficiently advanced in its financial and economic structure and the firms should be in the habit of keeping proper accounts.

(2) This system depends a lot upon the cooperation of the tax-payers. Each firm itself calculates its tax liability to begin with, and also finds out the taxes paid by the earlier firms. Once, however, the sellers realize that the administrative machinery of the government is ill-equipped to do all the necessary cross-checking, they will resort to the creation of false purchase invoices showing taxes paid by others. To the extent this happens, tax evasion becomes a major possibility and a common practice.

(3) Even if the tax-payers are all fully honest, this system of taxation forces them to maintain elaborate and costly accounts. This becomes highly uneconomical, especially for the smaller firms.

(4) The difficulties of maintaining accounts, cross-checking and preventing tax evasion become insurmountable if the system contains some exemptions (such as for food items) and differential rates of taxation (luxuries are likely to be taxed at higher rates than necessities). It would be naive to assume that a modern government would like to have a tax system which is claimed to be 'neutral' in its allocative and distributive effects. The realities of non-competitive markets, income and wealth inequalities, and (in underdeveloped countries) the need for quickening the pace of capital formation cannot be ignored. VAT has to be selective in coverage and with differential rates. The host of problems arising out of these exemptions and differential rates make this tax quite unattractive.

(5) The argument that VAT induces efficiency is not a tenable one in a shortage economy like ours where speculative hoarding, non-competitive price rise and similar practices are quite common. In a seller's market, it is doubtful whether VAT will edge the producers and sellers to increase their efficiency and reduce costs since goods will sell irrespective of their inferior quality and high prices.

All told VAT is a highly unwieldy tax system which cannot be administered with any degree of efficiency in an underdeveloped country

on account of its various limitations and its general applicability in advanced countries remains debatable. In India the concept of VAT was introduced in a limited form in the Central Government Budget for 1975-76 whereby all items which were not already subject to excise duties were subjected to an *ad valorem* duty of 1%. In subsequent budgets this rate was raised, becoming 8% in 1979-80. The Indirect Taxation Enquiry Committee (1976) in its Report in 1977 examined the feasibility of VAT system. It came to the conclusion that under our administrative and other circumstances, we should be cautious in adopting this tax form. It recommended the adoption of this tax, on an experimental basis, to a limited extent at the manufacturing level only—the so-called MANVAT.

EXPENDITURE TAX

The concept of expenditure taxation may be considered in three different contexts, namely, a form of commodity taxation, a form of personal expenditure taxation, and as a base for corporate taxation. Of these three forms, the most widely used one is that of commodity taxation in the form of excise duties, sales tax, turnover tax, value-added tax etc. These taxes are expected to be finally paid by the consumers. But this conventional form of commodity taxation may not turn out to be a fullfledged expenditure tax because of two things. *Firstly*, in this case all expenditure is not taxed and the tax liability is not linked to the *amount* of expenditure but to the *type* of expenditure. Moreover, the rates of taxation for different types of expenditure here can differ from each other, such as there being different rates of excise duty or sales tax on different items. It may be additionally recalled that commodity taxes may be specific for some items but *ad valorem* in the case of others which further curtails their collective quality of being an expenditure tax. *Secondly*, it is not essential that the incidence of commodity taxes would always be fully on the consumers. It may not be so.

Even if the above considerations were inapplicable and commodity taxation could be used as an acceptable form of expenditure taxation, it would stand discredited on grounds of equity. Though it is not an inherent feature of commodity taxes to be regressive, they tend to be so all the same. The authorities often choose to tax necessities because, being highly inelastic in demand, they are likely to yield more revenue.

Personal expenditure tax, however, has been a more favourite

subject for discussion with the theoreticians and other thinkers. It has often been viewed as an alternative to taxation of income. It was considered superior to income tax in a number of ways and was first mooted by Hobbes about three centuries ago. J.S. Mill considered it a perfect and equitable tax, especially because savings are exempted under it. It was put forth as an ideal tax by Alfred Marshall. Personal expenditure is considered as one of the indices of ability to pay and therefore a suitable base for determining the tax liability. In underdeveloped countries, it claims its worthwhileness by providing an encouragement to savings and investment. The concept, however, did not become very popular because of the administrative difficulties which it posed, till Irving Fisher pointed out a 'simple' method of estimating personal consumption expenditure. In a summary form it is estimated as income earned during the year adjusted by the net variation in the wealth of the tax-payer. In other words, it is equal to income earned minus net savings. The net savings may be taken as equivalent to the addition to net worth so that borrowing (which *reduce* the net worth) would indicate an addition to personal consumption expenditure while lendings wou'd correspondingly mean a reduction in it.

It is obvious that the determination of personal consumption expenditure for the purposes of fixing tax liability is quite complicated in spite of the 'simple' method suggested by Fisher. We have, for example, to determine the 'income' of the tax payer in much the same way as in the case of income tax itself. There are also certain other difficulties which we would note presently. If, therefore, personal expenditure tax is to score over income tax, it must be on economic grounds and not on administrative reasons. In the United States in 1942, the Treasury used Fisher's method in preparing a schedule of expenditure tax, but the administrative difficulties were admitted by the author of the scheme, Randolph Paul, himself. Of various administrative difficulties, especially in a country like ours, we can mention the paucity and inaccuracy of accounts. We have a very large number of people who are petty shopkeepers, hawkers, farmers etc. These people either do not maintain any accounts, or would combine accounts of their business and households. If we leave out this vast majority, the tax revenue collection would be quite inadequate. An effort to cover everybody would be administratively non-feasible. In our country, therefore, expenditure tax cannot replace the rest of the tax system. At the most it may be used to supplement it. In addition to these administrative difficulties, there are various conceptual problems. A definition of expenditure has to be provided

enabling us to distinguish consumption expenditure from gifts, charities, donations, transfers etc. A number of personal consumption expenditures may be recorded as business expenses in order to avoid the tax liability. Similarly, there is the intricate problem of durable consumer goods. Such goods are purchased in lumpy units (value-wise), but may be 'consumed' over a number of tax-periods. The complication increases when we think of the possibilities of capital gains, destruction of some durable goods, or their final junk value.

An important conceptual problem can arise in demarcating between consumption and investment expenditure. Apart from investment in physical and financial assets, it may be for augmenting 'human capital' (that is, for enhancing the productivity of the persons involved). For example, individuals do spend on their own education and training as also on the education and training of their children. Is this expenditure to be counted in consumption or investment? As noted above, a similar situation arises in classifying many expenses between business and personal consumption expenses. If the expenditure tax is progressive, there would be an inherent tendency on the part of tax-payers to divide the family into smaller units to escape its incidence. Further, unless the tax machinery of the government is efficient enough to trace out all the income receipts, the tax-payers may be able to spend a part of their incomes without attracting tax liability.

Traditionally, apart from administrative considerations, taxation of income has been advocated on various grounds, though on close scrutiny they are found to be defective. The first argument in favour of income taxation runs in terms of the concept of ability-to-pay. Soon, however, it is realized that the ability-to-pay is not proportional to income and this realization leads to the advocacy for progressive tax rates. But even then, it must be recognized that the amount of income and the ability to pay are not necessarily correlated. The needs of different individuals and families will vary on the basis of family size and other relevant factors. Similarly, the spending power of an income earner will be conditioned by the source from which income is earned (such as from property or from one's own labour), the regularity or otherwise of the income, the chances of earning similar income in future and the like. The second argument in favour of income taxation is based on the contention that income tax cannot be shifted. This is not necessarily so. In the case of very low incomes, a tax is likely to curtail the relevant supply of labour and cause an upward revision in the wage rates; in the case of higher incomes, supply of effort may be substituted by leisure.

On the other hand, a number of arguments can be put forth to make a theoretical case for personal expenditure tax. On moral grounds, an activity which drains resources from the common national pool (by way of consumption expenditure) should be taxed rather than an activity which adds to it (through effort and earnings). Moreover, expenditure tax does not distinguish between different forms or sources of income. Instead it relies upon an individual's decision to spend as an indicator of his capacity to spend. In so far as the *need* to incur extra expenditure on account of family size, etc. is concerned, a provision for such circumstances can always be made in the schedule of expenditure in about the same manner as is done in income taxation. Again, it is misleading to argue that personal expenditure tax is necessarily regressive in nature. Like income tax, it can be made sufficiently progressive to meet the criterion of equity. Moreover income-tax falls more heavily on those with irregular income because during phases of greater earnings they are subjected to higher income-tax rates. And the hardship becomes more intensified in taxing of capital gains etc.

Personal consumption expenditure tax is to be preferred over income tax in so far as the savings are concerned. Income tax penalizes an earning effort. Expenditure tax does not. Income tax is a kind of double taxation. It first taxes the whole of income including the saved part and then reduces the compensation for postponing current consumption by taxing the earnings on savings. Income tax is neutral between savings and consumption (unless specific concessions are provided for savings). This may be immaterial for advanced countries where there is no scarcity of capital. But in developing countries, the role of savings cannot be ignored. Income tax discourages an effective utilisation of savings for capital accumulation because future income from it will also be taxed. Expenditure tax does not tax income and therefore thrift and capital accumulation. Over time, those people who have a higher propensity to save are able to add to their income as compared with those who spend and get taxed for that. Kaldor argues that progressive income tax is a greater disincentive to work than an ordinary proportional income tax. This is because with rising incomes, the tax liability increases more than proportionately. Personal consumption expenditure tax is also expected to discourage wasteful and conspicuous consumption. Again, personal consumption expenditure tax is a great help in controlling inflation without curbing growth. This is because this tax works on consumption demand and therefore dampens the prices. Saving and investment activities, however are not

discouraged by this tax. They are rather stimulated on account of a reduction in tax liability (in the event of savings and a higher profitability of investment.

Expenditure tax is more to commend in business where it may be given the place of business income taxation. As has been argued elsewhere, shifting the base of corporate taxation from income to expenditure is expected to encourage economy and efficiency provided a suitable set of tax schedules for different items of expenditure is prepared. Such a shift may also help the economy in using taxation as a more effective tool in its efforts to reduce regional income balances, adopt employment-oriented techniques of production, and so on.

On theoretical grounds, a personal expenditure tax can be a strong aid to egalitarian efforts of the authorities. Replacement of commodity taxation by personal expenditure tax would distribute the burden of taxation more progressively. Together with income tax, it can be used quite effectively as a vehicle of progression with less disincentive-effects than would be the case with income taxation only. Supplemented by a shift in corporate taxation from income to expenditure, the total effect may be quite conducive for savings and capital accumulation.

In India, a personal consumption expenditure tax was introduced in 1957 on the recommendation of Nicholas Kaldor in his Indian Tax Reform.[18] The Second Five Year Plan had made a case for this tax. It recognized its theoretical merits, pointed out its administrative difficulties and suggested that this tax may be introduced on a limited scale on an experimental basis. However, the tax was levied with a good deal of exemptions. The yield from this tax was quite small (around sixty lakh rupees) and was considered a failure in discouraging wasteful and conspicuous consumption. In 1962, the tax was removed by Mr Morarji Desai. In 1964, however, it was reintroduced by the then Finance Minister, Mr T.T. Krishnamachari. It was argued that the Estate Duty and Gift-Tax favoured consumption which needed to be discouraged. But the tax yield remained as small as ever while the burden on the administration and the inconvenience to the tax-payers was enormous. And it was therefore finally abandoned in 1966. Recently in Britain a committee headed by the Nobel Laureate, Sir James Meade, on the reform of direct

[18]Ministry of Finance, Government of India, *Indian Tax Reform: Report of a Survey* by Nicholas Kaldor, 1956. Previous to that Kaldor had extensively argued in favour of such a tax in his book, *An Expenditure Tax*, George Allen and Unwin, 1955.

taxation has recommended that personal income-tax should be replaced by expenditure-tax and the corporate-tax should be replaced by a tax on company's cash flow. This is basically an extension of the concept of expenditure tax on corporate sector. It may be added that it is not easy to define and estimate true profits of a company, more so under inflation because of a lack of correlation between original cost of capital investment and its replacement cost.

CAPITAL GAINS TAX

Taxation of capital gains poses both conceptual and practical difficulties, and in theory there are conflicting opinions regarding the rationale or otherwise of taxing capital gains. Capital gains are a category of income, but they are occasional rather than regular and come in business income rather than non-business one. A capital gain accrues when the value of capital asset goes up, it is realized when the asset is sold. Therefore, the gain accrues over a period of time, but realized at a point of time. Since taxation of income is on annual basis, the question of taxing a capital gain creates a problem of bunching or timing. Should the capital gain be taxed on the basis of accrual or realization, and should the tax be collected at the time of realization or along with accrual itself? The result in each case would be a different one. Let us first assume that the income taxation is proportional. In that case, the total tax liability remains unaltered irrespective of the manner of its assessment or collection. But its collection along with accrual basis would be more burdensome to the tax-payer who may not have cash to pay it before realization of the capital gain and who would in any case lose interest on the tax paid now instead of later. If the tax is a progressive one then its bunching or timing poses a still bigger problem, since the tax liability would partly depend upon its bunching pattern.

Mostly a capital gains tax is levied with reference to its realization and its rates are progressive. It is sometimes argued that these two factors make it an unjust tax and therefore it should be either abolished or its rates should be lower. Abolition of this tax can be counter-argued on grounds of distributive justice. Capital gains are unearned increments brought about by market and development forces. The gains really belong to the society and not to the asset owner. Moreover, modern thinking favours the use of taxation for narrowing inequalities. Hence abolition of capital gains taxation is not viewed with favour on grounds of equity. However, we should note two points here. *Firstly*, there are certain assets which do not

yield an annual income but which would register a capital appreciation all the same. Equality of treatment demands that for tax purposes the capital gains on such assets should be reduced by the loss of income which could be obtained on an equivalent safe investment. Similarly, if an asset yields an income below the market rate, its capital gain should be reduced accordingly before taxation. *Secondly*, the basis of estimating a capital gain should not be the appreciation in money value of an asset, but an increase in its purchasing power. During the periods of rising prices, an asset may show a capital gain in money terms (with no real gain to the owner). It should attract a capital gains tax only if its price rises more than the one registered by a selected price index.

A complete exemption of capital gains from taxation militates against distributive justice and would encourage the manipulation of many normal transactions into capital gains. The argument that this tax hampers capital mobility and investment is not a valid one since various studies show that there is no direct relationship between capital gains tax and capital mobility. Therefore, given the fact that this tax should be there, the best practical method appears to be to tax capital gains at rates lower than those on regular income. Also capital losses in one year should be allowed to be adjusted against capital gains in the coming years. We should, however, remember that a number of conceptual difficulties are bound to remain unsolved and have to be treated by some arbitrary rules (such as in the problem of distinction between capital and non-capital transactions).

9 EFFECTS OF TAXATION

The effects of taxation, as we know, cover all the changes in the economy resulting from the imposition of a tax system (or a variation in it). One may say that without taxation. a market economy would attain certain production, consumption, investment, employment and similar other patterns. The presence of taxation distorts these patterns—for good or for bad—and such distortions may collectively be called the effects of taxation.

There was a time when under the influence of the *laissez-faire* philosophy, it was advocated that the State should have a neutral tax policy. In other words, the State, in order to perform its functions needed certain amount of revenue and that should be raised with no or minimum distortions in the economic parameters generated by the market forces. Such a reasoning may be presented by using the concept of "general fiscal rationality."[1] It implies that the fiscal action of the government should not disturb the resource allocation pattern of the economy and should, therefore, be neutral as between different sectors or should bring about the minimum possible distortions therein. To put it in different words, it is being assumed that in the market, the patterns of resource allocation and the production would conform to the social marginal rates of substitution between different goods and services.

Such a philosophy, it would be seen was based upon two fundamental assumptions. The first was that the market on its own creates economic parameters which are optimum or the best possible which the economy was capable of. The second assumption was that the State could raise tax revenue without undue interference in the working of the economy. Both these assumptions are unrealistic.

It is now well recognized that the market forces by themselves are not able to create the most desirable results in the economy. With complete freedom of market mechanism, trade cycles, inequalities of income and wealth, imbalanced growth and such like things emerge. Actually the belief that the market mechanism will be able to bring

[1]Bernard P. Herber, *Modern Public Finance*, Richard D. Irwin, Inc., 1967, p. 213.

about such an optimum allocation of resources is based upon certain implicit conditions which are not satisfied. One such condition is that the market is perfectly competitive. In general, we know, there are all sorts of imperfections caused by irrational consumer behaviour, monopolistic practices of the suppliers, technical rigidities, imperfect knowledge of the market, and so on. Another stringent condition which must be satisfied for optimum, allocation of resources is the absence of externalities of goods. We have seen, while discussing the public goods, that this characteristic is not satisfied in their case. Similarly, another difficult condition which is again not satisfied is that the principle of exclusion should be applicable to all goods.

Secondly, these days a modern State needs quite a sizeable revenue which forms a significant proportion of the total national income. The sheer size of this tax revenue shows that it cannot remain neutral in terms of its effects upon the economy.[2] Even if the authorities so want, taxation policy cannot be neutral. Furthermore, there is a positive need to remove the defects created by the market mechanism. Since taxation has all-penetrating effects, it becomes an effective tool in adopting various corrective measures. Such corrective measures would really be the ones which will deliberately distort market decisions in consumption, investment and other spheres. Hence far from saying that taxation should be neutral, the real point at issue is in what way taxation should be used so as to reap the maximum social benefits from the working of the economy. The task of the taxation policy should be to help the economy achieve that combination of different goods which would conform the social marginal rates of substitution between them to their technical rates of substitution. The same idea may be generalized for the economy as a whole in terms of division between public and private goods. This is illustrated in Fig. 9.1.

Let the production possibility curve, showing the possible combinations of public and private goods which can be produced from the use of the economy's resources be given by *AB*. Let $I_1, I_2, I_3, \ldots$ be the social indifference curves showing different combinations of private and public goods which are equally preferable to the society. Then, the optimum allocation between the public and private goods should be as shown by point *E*. Any fiscal action which brings the economy nearer it would be contributing towards the allocative efficiency and any fiscal action pushing the economy away from point *E* will like-

[2]Otto Eckstein, *Public Finance*, Foundations of Modern Economics Series Ch. 6.

wise be harmful to it.

We should remember that the use of taxation in the type of economy we are considering will not be to destroy the market mechanism, but to guide and regulate its working. Therefore, all tax measures would work through their influence on the demand and supply forces in the market

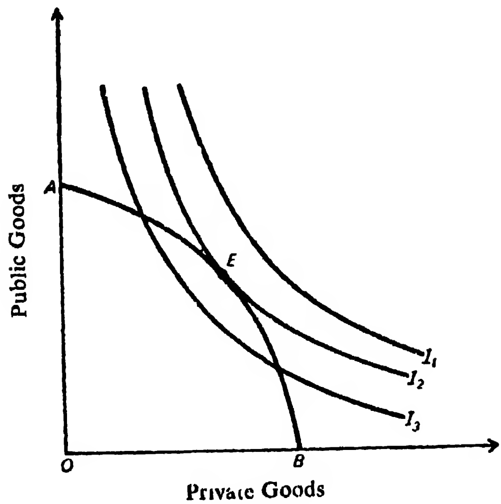


FIG. 9.1

Secondly, the tax measures either reduce the disposable income of the buyers (individuals, firms, and so on) and thereby affect their demand, or they have an important bearing upon the economy through supply effects of taxation. Such reaction, of course, would partly depend upon their elasticity of demand for various goods and services. Similarly, the reaction of the suppliers, which would partly depend on their elasticity of supply, would be a major determinant in the detailed results.

And on account of the shifting of incidence, both demand and supply reactions may get mixed up leading to further rounds of effects. Pigou calls these distortions in the market behaviour resulting from the imposition of taxes as their "announcement effects." There can be various ways of looking at the effects of a tax system. We may, for example, begin with the fact of tax imposition itself which will reduce the disposable income of those upon whom the statutory responsibility of paying the tax rests. In this case the next stage of effects will be the fact of incidence. Between the impact of a tax and its final incidence, a number of changes would take place. Thus, the distribution of the final reduction in the disposable income may be quite different from the initial one associated with its impact. And then come the effects resulting from the incidence itself. In the same manner, we could analyze the effects of taxation on an aggregative or non-aggregative level. The choice would depend upon the purpose of our analysis. In other cases, the discussion of the effects could run in terms of comparing the effects of different taxes on the working of

the economy.

We shall confine our discussion of the effects to more or less aggregative level—the possible behaviour of a typical economic unit will be considered mainly to enable us to find out the aggregative effects for the economy as a whole. Furthermore, it must be remembered that various effects of tax measures may be counterbalanced by those of public expenditure. For example, if public taxation reduces the savings on the part of the people, the government sector may save to counteract that to some extent. Such counter-balancing effects, moreover, can be there even in the private sector of the economy. For example, the government might be neutralizing its profit tax by giving subsidies to a particular industry. We shall, however, abstract from these effects of public expenditure and concentrate only upon the effects of taxation and that also only in the private sector. Four important categories of effects will be chosen by us for discussion, namely, those on production and growth, on distribution, on economic stabilization, and on inflationary pressure.

EFFECTS OF TAXATION ON PRODUCTION AND GROWTH

In line with Dalton, the effects of taxation on production and growth may be analyzed with reference to (*i*) capacity to work, save and invest; and (*ii*) the will to work, save and invest. An alternative way of analyzing these effects would be to split them up into (*a*) a shift in the allocation of existing productive resources and (*b*) a change in the supply of these productive resources and use them as manifestations of the capacity (and will) to work, save andinvest. It must be emphasized that different dimensions of these effects are highly interdependent and it is only for analytical simplicity and comprehension that the problem is split up into its component parts. In the following paragraphs we shall take up some of the detailed points of this analysis. However, it should be noted that it is not possible to determine quantitatively the effects of any taxexcept in a specific case study, and therefore our treatment of the problem will be to state the general direction in which an effect manifests itself. In some cases we shall also try to find out as to which tax has more of a specific effect and which one has less.

Allocative Effects of Different Taxes

Here it would be helpful to lay down the conditions under which the existing allocation of resources may be termed an optimum one. This would be followed by an analysis of the way in which a given

tax is likely to shift the existing resource allocation which in turn should help us in drawing certain inferences.

It was a tradition with the economists to assume that a competitive market economy working with sufficient factor mobility would result in an optimum allocation of its productive resources. Optimum allocation is defined as the one in which the relevant marginal conditions are satisfied. It means, for example, that in the field of production, the ratio of marginal productivity of a factor to its market price is equal to the similar ratio of every other factor. Similarly, marginal rate of substitution between any pair of goods is equal to the marginal rate of technical substitution between them. In the same way, there is no divergence between social and private marginal costs and between social and private marginal benefits of the employment of any factor. These days, however, it is recognized that such an optimum allocation of resources is optimum with reference to a given income distribution only. If income distribution in the economy is not itself an optimum one (and the decision regarding what is optimum distribution of income is a matter of value judgement) then the so called optimality of resource allocation would not reflect the true needs and preferences of the society. It would be reflecting only the best allocation that may be obtained under a given income distribution. A market economy would give rise to a specific demand pattern for different goods and services in harmony with the pattern of its income and wealth distribution. The demand pattern, through its impact on profitability of various economic activities would guide the market to a given production and resource allocation set up. If therefore, we have a reason to believe that the existing income and wealth distribution in the society is not an 'optimum one (and we know that a market economy generates and widens inequalities), we will not be able to accept the existing resource allocation as an optimum one, especially if the market is also riddled with various imperfections like those of imperfect factor mobility and monopoly elements.

Marshall recognized the possibility of a sub-optimal allocation of resources as between different industries. He approached the problem by comparing the effect of a tax on consumer's surplus with the amount of tax collection. If the loss to the consumer's surplus was less than the tax collected by the authorities, then the shift of investment out of the taxed industry was considered beneficial to the society and therefore a step towards optimum resource allocation. On this basis Marshall was able to conclude that the output of an industry operating under diminishing returns should be taxed, while

the output of an industry operating under increasing returns should be subsidized. A constant returns industry was to be neither taxed nor subsidized. Further it was found that in certain cases, *ad valorem* and specific taxes would have different effects on the production of a good. The effect of two taxes would be the same in the case of a constant returns industry (which has a perfectly elastic supply curve) provided the yield from the two taxes is the same. In this case the supply curve inclusive of tax would run parallel to the supply curve without tax. In the case of a supply curve rising upwards to the right, the vertical distance between the supply curve inclusive of tax and the original supply curve would keep on widening as supply increases. This means that the addition to the supply price increases as output increases. On the other hand, in the case of an increasing returns industry, the absolute addition to the supply price falls with increasing output. For this reason, an *ad valorem* tax has a more pronounced effect on the supply of a good being produced under diminishing returns and a less pronounced effect on the supply of a good being produced under increasing returns. It can also be shown that under oligopoly with a kinked demand curve, if an indirect tax shifts marginal cost curve within the limits of vertical range of the marginal revenue curve, the output of the oligopolist would not be affected. Marshallian reasoning, as it stands, is quite deficient. It assumes that the tax revenue in the hands of the authorities yields an equivalent benefit to the society while the loss to the society is equivalent to the tax collected. Both these assumptions can be refuted easily. Further, Marshall ignores the effect of taxation on producers' surplus in this theorizing. He also makes the mistake of deciding the social priority of an industry on the basis of its cost behaviour. To him diminishing returns industry should be discouraged and an increasing returns industry should produce more. However, the c consideration lead us to infer that the authorities may be able to pick up a judicious set of indirect taxes on a selective basis for realising a desired shift from the existing allocation of productive resources. Such a possibility is of great policy relevance in a country like ours where investment in high priority industries is to be encouraged.

Marshallian reasoning, coupled with Dalton's treatment of sharing of tax incidence between the buyers and sellers leads us to the inference that, given the elasticity of supply, the effect on demand for a good will be directly related to its demand elasticity. Goods with higher elasticity of demand would be affected more and those with lower elasticity of demand would be affected less by a given tax rate. This implies that the extent to which a given tax on commodity

would reduce its output and release resources for other industries would depend upon its elasticity of demand. Similarly, a good with a higher elasticity of supply would be affected more by a tax on it than a good with a lower elasticity of supply. Goods with zero elasticity of supply or demand would not be affected at all by a tax on them and such a tax would have no effect on resource allocation. This analysis, therefore, tells us that we should consider the relevant elasticities of demand and supply of a good while using an indirect tax to shift its production and resource appropriation. But it still fails to tell us the way a tax should be distributed between commodities having same elasticity of demand but different elasticities of supply, or between commodities having same elasticity of supply but different elasticities of demand, or commodities having different elasticities of both demand and supply.

The discussion of the allocative effects of indirect taxation would not be complete without bringing in the fact of income redistribution by it. Indirect taxation is pro-inflationary and widens income and wealth inequalities in the economy. This in turn shifts demand relatively in favour of luxuries which, ordinarily, a less developed economy can not afford. The result is a shift in the allocation of resources toward luxuries at the cost of necessities. Unless, therefore, indirect taxation of commodities is highly selective with reference to coverage and rates and takes into account their respective elasticities of demand and supply, it can prove a dangerous instrument in the hands of the authorities. On these grounds, therefore the case for a selective commodity taxation is very strong in a country like India.

Let us, however. start with the assumption that the existing resource allocation is an optimum one and see the relative allocative effects of direct and indirect taxes. Though any tax will have both allocative and distributive effects, we would ignore the latter for the sake of simplicity of the argument. Also we would assume that the economy is having a state of full employment and there is no variation in the total supply of a factor. This implies that greater employment of a factor in one use can be had only by reducing its employment in another use. It should be noted that in a market economy, resource allocation would be guided by demand pattern. It would be, therefore, helpful to proceed by analyzing the allocative effects of a tax by looking at the way it would influence the demand of a typical individual who may be taken to reflect, on the average, the tastes, ability to enjoy income and so on of the society as a whole. Further, since we cannot take up the comparison of the allocative effects of direct and indirect taxes as a whole, we must choose a representa-

tive direct tax and compare its allocative effects with those of a representative indirect tax, assuming all the while that the government collects an equal amount of tax revenue either way and the expenditure side of its activity is unaffected by its choice between the two taxes. For this purpose it is typical to choose a proportional income-tax on the one hand and an indirect tax on a given commodity on the other.

Thus in the above framework we take up a typical consumer who is supposed to spend all his income between two goods X and Y. Using the usual technique of indifference curves, we note that (see Fig. 9.2) our consumer has a budget price line A_1Q_1 and is in equilibrium at point E_1 enjoying an amount of satisfaction represented by the indifference curve I_1. If the authorities impose an indirect tax on commodity X, its price would rise and the consumer would be able to buy a smaller quantity, say OQ_3. His new equilibrium position would then be at E_3 and he would slide down to a lower

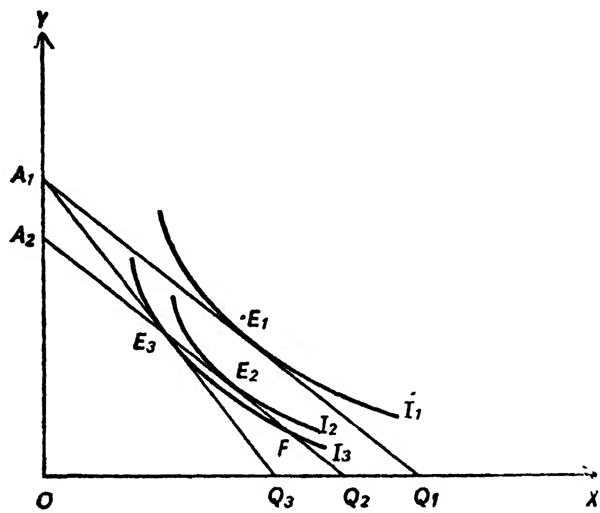


FIG. 9.2

indifference curve I_3. Now let the authorities impose an equal revenue yielding direct tax, so that the post-tax budget price line A_2Q_2 of the consumer shifts downwards and lies parallel to A_1Q_1. It would pass through point E_3 because the direct tax must yield same revenue as the indirect tax did. However, it is seen that A_2Q_2 would intersect I_3 at E_3 and lie above it between E_3 and F. The consumer would therefore be able to move on to a higher indifference curve I_2 by increasing his purchases of X and by being at E_2.

This analysis, with the assumptions upon which it is based, is used to make two assertions:

(*a*) An indirect tax is more burdensome than an equal yield proportional income-tax in terms of sacrifice of utility by the tax payers;

(*b*) Indirect taxes cause a greater distortion in the allocation of resources and for that reason are more burdensome than direct taxes.

The assertion (*a*) has been analyzed in detail in another chapter. Here we are primarily concerned with assertion (*b*). We note that according to our assumptions, E_1 represented an optimum production pattern. Direct proportional income-tax shifts the demand pattern and therefore causes a distortion in the optimum allocation of resources. However, this distortion is due to the *income effect*, since taxation has caused a reduction in the disposable income of the tax-payers. On the other hand, an indirect tax causes *both* a reduction in disposable income of the tax-payers as also a shift in the relative prices of X and other goods. X becomes costlier as compared to the untaxed goods. This causes a *substitution effect* leading to a reduction in the demand for X over and above the income effect. Therefore as between a direct and an indirect tax, the latter causes a greater distortion in the resource allocation.

The above conclusion according to which indirect taxation is inferior to direct taxation in terms of resource allocation is based upon the assumption that a shift in resource allocation on account of substitution effect of indirect taxation is *away* from the optimum. This however need not be so. If an economy is using too many resources for the production of good X, then indirect taxation of X should help the economy in moving closer to the optimum resource allocation. And we should not forget that the existing income distribution in the society may itself be causing an allocation which does not reflect true needs of the society. The thrust of the argument is that in case the existing pattern of resource allocation is believed to be in need of an improvement, then indirect taxation would be a better instrument than direct taxation.

This aspect of possible superiority of indirect taxation over direct taxation in resource allocation may be illustrated by extending the above model. Let us now bring in the production possibility curve *PR* of a representative producer, so that in conjunction with the indifference curves of the representative consumer and his budget price line A_1Q_1, E_1 becomes a point of double equilibrium, that is at E_1 both the marginal rate of substitution between X and Y and marginal rate of technical substitution between X and Y are equal

to the price ratio between X and Y as represented by the slope of the line A_1Q_1. In order to eliminate the income effect which is same in both direct and indirect taxes, let us assume that the authorities

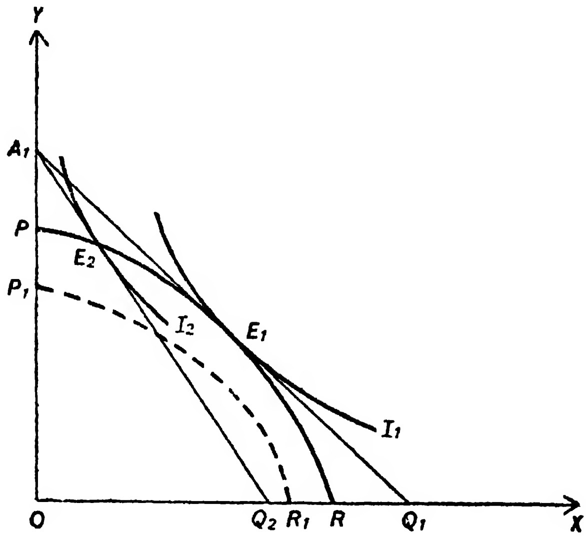


FIG. 9.3

pay back the collected tax to the private sector by way of grants, so that the private sector retains the same amount of productive resources and the production possibility curve of its representative producer remains unchanged instead of shifting to a position like the one shown by the dotted line. It also follows that the point of double equilibrium would also stay. The assumption regarding transferring back of collected tax revenue is ignoring the fact that the tax-payers and the recipients of grants can differ and this can cause a shift in the demand pattern and hence indifference curves of the typical consumer. But let us proceed in spite of this limitation of our argument. Now, a direct tax does not cause a substitution effect between X and Y because their relative prices are not affected. Therefore, if the authorities collect a direct tax and transfer back the tax proceeds there is neither an income effect nor a substitution effect, and our typical consumer remains at E_1. On the other hand, an indirect tax would have no income effect when its revenue is transferred back but its substitution effect would remain same because relative prices of X and Y would not return to the original position. Thus an indirect taxation would cause a shift in resource allocation.

However, if due to market imperfections or due to income inequalities, the existing resource allocation is not considered an optimum

one, then indirect taxation would be a better instrument in causing a shift *towards* optimum. If resources in commodity Y are too few, X should be taxed and if resources in commodity X are too few, Y should be taxed. For example, let us say that the existing resource allocation for X and Y is represented by point E_2 where the consumer is at indifference curve I_2 but where marginal rate of substitution between X and Y given by the slope of the line A_1Q_2 is not equal to the marginal rate of technical substitution between X and Y. Therefore here the need would be to change the relative prices of X and Y such that X becomes relatively cheaper and production pattern comes closer to the one represented by E_1.

In practice, the allocative effects of indirect taxes would be superior to those of direct taxes provided the government chooses the indirect taxes judiciously. In an underdeveloped economy, there is a need to shift the resources toward various priority industries and indirect taxes can be of help there. Even in a modern developed economy, there are usually numerous imperfections, monopolies and so on, as also a good deal of divergence between social and private costs on the one hand and between social and private benefits on the other. However, we should note that production of certain high priority goods may be lower not because resources invested in them are too few, but because due to market imperfections there are unutilized capacities as in the case of monopolies and monopolistic competition. The appropriate approach in breaking a monopoly is not to push more resources into it (as suggested by Prest) through taxation of goods produced by competitive industries and subsidizing the goods produced by monopolies. Instead steps should be taken whereby monopolies are forced to make use of their unutilized capacities.

Another reason on account of which a judicious use of indirect taxes turns out to be better than direct taxes in their allocative effects is the fact that it is rather difficult to have a really proportional income taxation. The very concept of taxable income is an imprecise one, and its definition differs from country to country and even within the same country from time to time. We do not have even theoretical standards by which to measure the income of an individual or a family. Problems relating to the imputed valuation of self-consumption, income from durable consumer goods and so on are still unresolved. Similarly, it is not easy to lay down exact standards by which to estimate the expenses for earning the income, or by which to estimate the depreciation. In a modern economy, due to changes in prices and other uncertainties, there are capital gains, windfall profits and casual incomes, which pose difficult problems of

devising a system of proportional income taxation.

In practice, the above comparison between the allocative effects of a proportional income-tax with those of an equal-yield indirect tax is an academic exercise only, since a modern government is expected to prefer a progressive direct income-tax with an exemption limit to a proportional income-tax.

This leads us to compare allocative effects of different direct taxes themselves. To begin with we should note that a direct tax will have a resource allocative effect by changing the relative attractiveness of different sources of income. On this basis, therefore, we can state that a supplier of labour would shift from one employment or industry to another if by so doing he can reduce his direct tax liability more than the reduction, if any, in his earnings from the supply of his labour. If he finds that by shifting his employment, his tax liability remains unaltered, there would be no reallocative effect on existing labour supply in the economy. Similarly, a tax which does not change relative profitability of different forms of investment, or relative rates of returns from different forms of wealth, would not cause a reallocation of capital resources. This argument may be further elaborated as follows. Assuming that the savings have already taken place, the question is about the form in which savings are to be kept. Some of these savings would be in the nature of just hoarding without any income while others would be fetching returns at various rates. Now if in general taxation reduces one's earnings from each type of investment substantially, then there will be a tendency for savings to go uninvested or get invested into those lines from which little or no income may be expected. People, for example, might keep their savings in the form of gold, stretches of landed property, and so on. This would be more so if the capital value of these assets is expected to appreciate.

Taxation of earnings from investment would tend to reduce the supply of savings and investment in general. But a system of differential taxation causes a resource reallocation effect also. If for example, houses are taxed lightly compared with profits from business, investment in housing will be encouraged. Within various types of business investments also, differential tax measures will have an important bearing on the choice of investments. Thus, the industries which are allowed a high rate of depreciation allowance will find their net profitability higher and therefore will attract investment in preference to the others. The authorities can make use of tax concessions and penal taxes to divert investment from low priority to

high priority industries. Differential taxation can also be used to influence the location of industries. And the same approach is available for promoting certain techniques of production. This fact can be used to help those industries which contribute towards a rapid capital accumulation in the country or those which foster growth in employment. The above reasoning would also point out that a poll tax would have no reallocative effects either on existing supply of labour or on existing supply of capital. This is because under a poll tax, the tax liability of an assessee is determined in absolute terms without reference to either the amount or the source of his income.

The above considerations enable us to have a closer look at the allocative effects of various direct taxes. This we may do by offering some comments on the allocation of labour and then that of capital. An allocative effect on labour is exercised through a variation in the relative attractiveness of wage incomes from different employments relative to the disagreeableness of those jobs. In general, less agreeable employments carry higher wage rates. A proportional income-tax would reduce the absolute difference between the two wage rates, but the percentage difference would remain the same. A progressive income-tax would reduce the difference in both absolute and percentage terms. Let us take an example. Suppose the wage rates in two employments I and II are respectively Rs X and Rs $1.5X$ per month. Thus wage rate in employment II is 50% more than in employment I. Let a proportional income-tax at the rate of 20% of income be levied now. This would reduce the post-tax wage incomes to Rs $0.8X$ in employment I and Rs $1.20X$ in employment II. The absolute wage difference is now reduced to Rs $0.4X$ as compared with Rs $0.5X$ earlier but the wage rate in employment II is still 50% more than in employment I. On the other hand, let the income-tax be progressive, say 20% at an income of Rs X and 30% at an income of Rs $1.5X$. Then the post-tax wage rates would be Rs $0.8X$ in employment I and Rs $1.05X$ in employment II. This reduces the absolute difference between the two wages to Rs $0.25X$ and makes the wage rate in employment II only 31.25% higher. Prest argues that a proportional income-tax would reduce the compensation for less agreeable employment and would cause a shift of labour out of it. By the same token, a progressive income-tax will have a greater reallocative effect on labour.[3] However, it should be noted that an appropriate wage compensation for a less agreeable employment

[3]A.R. Prest, ***Public Finance in Theory and Practice***, **5th edn., English Language Book Society and Weidenfeld and Nicolson, 1974, Ch. 3.**

ought to be not an absolute amount but a proportion of wage in the more agreeable employment. On this basis both poll tax and a proportional income-tax should have no reallocative effects on labour, but a progressive income-tax should cause a shift in labour from less agreeable into more agreeable employments.

Let us now consider the allocative effects of different taxes on capital. But before considering these effects, let us note that investments are not to be classified between less agreeable and more agreeable ones, but between more risky and less risky ones. A more risky investment is the one the return from which is subject to a greater variation. In line with Harry Markowitz, J.R. Hicks and G.L.S. Shackle etc., we may look at the mean expected return (Ey) and the standard deviation of the expected return (σy) to put the concept of riskiness in more precise terms. A more risky venture is that which, with given Ey, has a higher σy. A more risky venture, should, therefore carry a higher Ey to compensate for that extra risk. If therefore an income-tax reduces the compensation for a risky venture, it would cause two effects. In terms of substitution effect, more risky ventures would become less acceptable to the investors, and capital resources would be reallocated in favour of less risky ventures. This substitution effect would be stronger if income-tax is progressive instead of proportional. There would also be a reduction in income from investment (and a greater reduction in income from more risky ventures). Whether investors, on account of lower income, would start preferring safer ventures more than previously, or whether they would go in for still more risky ventures to compensate for that loss of income due to taxation cannot be said with certainty. It would depend upon the capacity and will of the investors to bear risks. We may however add that a poll tax does not discriminate between either the amount of income or its source and is therefore neutral between different investments.

The above discussion can be further elaborated in the light of the provision or absence of a loss offset. Absence of loss offset means that a positive income is subject to taxation but the tax authorities do not share the losses of investors, nor do they allow them to adjust the loss in one year against the income of another. In such a case, a risky venture automatically gets discriminated against if income-tax is progressive, since its after-tax average return Ey falls more than proportionately as compared with the fall in Ey of a less risky venture. A proportional income-tax on the other hand does not discriminate against a risky venture unless its income falls to a negative figure for some intervals.

If income-tax allows offsetting of a loss in one year against income in another year, then the average tax liability per annum is not affected by fluctuations in the yield. Instead it is determined on the basis of average yield *Ey* from a venture. Therefore, a proportional income-tax does not discriminate against a risky venture if complete loss-offset is allowed. The result with regard to a progressive income-tax is however not that clear. It would largely depend upon the degree of progression in the tax rates and the timing of losses and gains and the way the loss-offsets are allowed. Ordinarily, progressive tax rates would tend to shift the *Ey* of risky ventures downwards and cause a reallocation of capital in favour of less risky ventures. Thus we find that as compared with a poll tax, income taxation often discriminates against risky ventures unless it is proportional and allows a complete loss-offset.

The allocative effect of a tax on capital would depend upon its form and coverage. A once-over capital levy will leave the relative attractiveness of different capital assets unchanged, but an annual levy would not. Different capital assets do not yield income at the same rate and some assets have no yield at all. An annual tax on capital brings about a shift in the relative attractiveness of different capital assets. This is further compounded by the fact that many capital assets pose problems of valuation. In any case depending upon the nature of the effective shift in the relative attractiveness of capital assets, the investment allocation would be affected. Capital resources would tend to move out of less attractive into more attractive forms of investment. In practice the relative attractiveness of capital assets is also affected by the efficiency of tax administration and other legal provisions. If, for example, capital invested in houses or agricultural lands is not taxed, or is taxed at lower rates, or can be evaded due to ineffectiveness of tax machinery, the shift of capital assets into these forms would take place.

Another form of capital taxation is that of gifts. It means that when a capital owner transfers its ownership during his lifetime without a payment, the transfer is subjected to a tax which may be imposed on the giver of the gift, or its recipient, and the tax amount may be determined with reference to the value of the gift or the paying capacity of the giver (or the recipient) or both. It is obvious that this form of capital taxation would have no allocative effect on capital. Similarly, taxation of capital may be in the form of a death duty or an estate duty where (the property left by a deceased is taxed before it is transferred to the inheritors) or an inheritance tax (where the property is first transferred to the inheritors and then taxed).

Clearly, these taxes may affect the *desire* of a person to save but not the *form* in which savings are kept unless these taxes discriminate between different forms of capital being inherited.

Expenditure tax is generally discussed in the context of its effects on supply of savings and capital formation, but it has certainly its resource allocative effect also which may be looked into. Expenditure tax is considered to be neutral as between different forms and amounts of income and therefore neutral as between different employments of labour and capital. However, let us consider expenditure tax on both personal consumption and business expenditure turn by turn and see if the conclusion regarding allocative neutrality of expenditure still holds. *Firstly*, we note that in order to yield same revenue as that of an income-tax, the rate of an expenditure tax would have to be higher because this tax necessarily exempts savings. Let us first take a proportional expenditure tax on personal consumption, which would imply a higher tax liability on those who consume luxuries because they are generally priced higher. This should exert a relatively greater depressing effect on demand for luxuries and therefore should tend to shift the resources from the production of luxuries to that of necessities. A progressive consumption expenditure tax would strengthen this tendency still further, because ordinarily expenditure on luxuries takes place only after consumption requirements of necessities has been met.

The position with regard to a tax on business expenditure is as follows. If the tax is confined to investment expenditure only, then expenditure tax would tend to favour risky ventures because a risky venture carries a higher average rate of return as compared with a safe one. This form of expenditure tax would also favour labour-intensive techniques and help reduce unemployment. If the base of the expenditure tax is taken as the entire business expenditure, then ventures (especially trading ones) with greater turnover would attract greater tax liability and would be discriminated against. Business ventures with smaller turnover and higher rate of return like house-building would get a fillip while activities like wholesale trade would suffer. The effect on financial institutions would be the worst. In practice, however, we should expect a good deal of exemptions and progressive rates even in business taxation. The above conclusions would stand modified in the light of the coverage and rates of taxation etc.

It should be noted that in the foregoing analysis we have ignored the fact that a direct tax can also have an indirect effect on resource allocation. Through a shift in income distribution or even otherwise.

a direct tax can lead to a shift in demand pattern and cause a reallocation of productive resources.

Effects of Taxation on Supply of Resources

The analysis of the effect of a tax on the supply of a factor of production should cover its total supply as also its utilisation. The response of different productive resources in this context would vary from factor to factor. Moreover, a number of non-tax forces are known to have a strong determining influence here. For example, the response of land to a tax in terms of its supply is likely to be near zero while its response in terms of utilisation can be quite significant. Similarly, in the case of labour, a number of long term forces come in to determine the total labour supply and its productive efficiency. It would be therefore more meaningful to discuss the effect of taxation on the supply of labour in the restricted sense of its utilisation. In the case of capital, annual accretions through supply of savings and investment appear to be as important as the shifts in its utilisation. But here also a number of non-economic forces exhibit their strength. For example, given the institutions of private property and inheritance, most people would like to save for old age and emergencies as also for their children. Similarly, in some societies, building up property might bring a social prestige in which case people will save in spite of taxes.

A few general comments would be in order as regards the effect of taxation on the supply of savings. We should think of not only the will to save, but also the capacity to save and investment in this context. With the degree of inequalities of income and wealth which we usually come across in the market economies, the saving potential is usually concentrated with the upper income groups. This tendency is especially very strong in underdeveloped countries. This implies that in order to create and maintain a capacity to save, we should leave out the richer sections. In other words, here the policy precondition is that of regressive taxation. Such a policy, however, not only goes against the distributive objective of a modern welfare State, it also creates a lot of social and political unrest. Regressive taxation cannot be used in exclusion of other taxes. To some extent its use may be necessary, especially in underdeveloped countries where the total saving potential is limited as compared with the needs for economic growth and capital accumulation. But it certainly cannot be relied upon as an exclusive source of State revenue. Moreover, any excessive use of regressive taxation will reduce the capacity to work also. In an underdeveloped country, where total voluntary saving potential

is very small, the State might decide to step in and save on behalf of the community. In that case it will have to tax the poorer sections also. In other words, in an underdeveloped country, there can be a conflict between immediate consumption and future consumption (through capital accumulation and growth). The State has to resolve this conflict as best as it can. To the extent, however, that some foreign aid becomes available, or certain untapped resources can be exploited, it will be possible to resolve this conflict more easily.

This brings us to the question of capacity to invest which is clearly connected with the capacity to save though the two are not identical. As an individual economic unit, a person or a firm may be able to save but not able to invest for various reasons. Similarly, it may not be able to save but still may be able to invest. For example, an economic unit may be able to save, say, through tax evasion and may not be able to invest the savings openly. Similarly, it may be able to save in a normal way, but opportunities to invest may be blocked through taxation and other measures. While referring to the capacity to invest, therefore, we assume for the sake of simplicity that the economic unit will not be debarred from investment on account of any non-economic causes, such as non-availability of permits and licenses, and so on. Such like measures, in conjunction with taxes, may be designed to push investment from one line into the other, but not more than that.

For an individual economic unit, as noted above, saving may not be essential for investment. It might even borrow from banks and other financial institutions to finance its investment operations. But for the economy as a whole such a procedure is not possible. There the financial institutions will be basically channelling the savings of the community into the hands of investors and thereby enabling them to invest. If through credit creation etc., an extra investment is attempted, then it will force extra savings upon the community through increasing prices and reduction in consumption. Such is the technique which lies behind financing of various projects through deficit financing by the government. However, a policy of forced saving may be desirable up to a certain limit but not beyond that because it will create inflationary pressures in the economy with its attendant defects and evils.

Given the fact that there will be financial institutions and mechanism for collecting the community's savings and bringing them to investors, the level and pattern of investment will be greatly influenced by the taxation in the country. This is because the investors are basically interested in making profits and the profitability of

investment can be affected through various tax measures.

Firstly, we note the possibility of taxing savings themselves. If that happens then the investors will naturally be able to come across smaller volume of savings and the overall level of investment in the country will decline (unless this is counterbalanced by other forces, such as an increase in the community's capacity to save, or the savings on the part of the government).

Secondly, the authorities might tax the earnings from investment to such an extent that it might become a problem for the firms to raise adequate resources in the market. The capital market might 'dry up.'

Thirdly, if the retained profits of the firms are taxed, they will not be able to depend much upon their internal resources for expansion. Instead they will borrow and invest if at all they do so.

This will again tend to dissipate a part of profits by way of interest payments which might be consumed away—at least in part. Also this will necessitate additional savings on the part of economic units other than the firms, if the total flow of capital formation is to be maintained. All told, the total capacity to invest is likely to decrease as retained profits are taxed. In the same manner, if the firms and corporations are subjected to a high level of taxation, two effects are likely to take place. *Firstly*, the pre-tax rate of profit will have to be higher for any investment to be worthwhile. This implies an all round downward pressure on investment. *Secondly* these institutions come to a belief that they can increase their expenses without proportionately reducing their profits. For example, if the marginal rate of tax is 60% on the profits of a firm, it will find that an additional expenditure of Rs 100 (and so a reduction of pre-tax profit by Rs 100) reduces its tax liability by Rs 60 and so its after-tax profit is reduced by only Rs 40. Because of this, therefore, under heavy taxation the firms tend to spend lavishly on office buildings, air-conditioning, furniture, cars, phones, allowances to the officers, and so on.

Other taxation factors also affect the capacity to invest. For example, if the firms are allowed to carry on losses from one year to the other, then over a number of years the average tax liability may be reduced and the firms may acquire greater resources for investment. If on the other hand, losses cannot be carried over, then though during the year of loss, a tax is not paid, in the year of profit full tax payment falls due. Similarly, in the case of VAT, a firm pays a tax on the value added without reference to the profits earned. This again further reduces its capacity to invest during the years of no profit. Likewise, if the firms are subjected to wealth and property taxes also,

their total assets will decrease and their expansion capacity and borrowing ability will suffer.

For an underdeveloped country, all these considerations have a special bearing. The need in such a country is that of not only rapid capital accumulation and economic growth, but also economic growth of proper type of industries together with regional balances. Accordingly, such a country should be adopting such taxation measures which do not cut at the sources of capital accumulation as such and which permit the use of funds for expansion and creation of new assets. Furthermore, taxation must discriminate between different types of industries—taxing those in low priority and exempting or taxing lightly those belonging to the high priority list. In order to encourage high priority industries, they may be granted tax holidays and increased depreciation allowances. These devices basically amount to permitting them to retain more funds for investment out of their earnings and increase the profitability of the investment. The same policy can be extended with respect to industries in relatively underdeveloped areas.

The above discussion may now be supplemented by some more comments regarding the effects of indirect taxation, income taxation expenditure taxation and capital taxation on the supply of savings. Savings result from the postponement of current consumption of income. The saver compares the expected satisfaction of future consumption with that of current consumption. Ordinarily, the expected future satisfaction from a given consumption is believed to be smaller; and therefore savings take place when there is a lure of interest income on savings. If, for some reasons, certain individuals view their future needs as strong or stronger than those of today, then such individuals may save at zero or even at a negative interest. Given these possibilities, an indirect tax on commodities would reduce the purchasing power of current income. This throws up numerous alternatives, depending upon the expected level of indirect taxation in future, current coverage of direct taxation and income effect on demand for goods. The exact response of savings would depend upon the combined effects of all these forces. Thus, in the case of selective commodity taxation, if commodities with inelastic demand are taxed, the expected effect should be an increase in consumption expenditure of tax payers and a reduction in their savings. On the other hand, if selective taxation is on goods of high demand elasticity, it would reduce consumption expenditure and should therefore increase savings.

An indirect taxation has the effect of widening income inequalities

through inflationary rise in prices and this fact should encourage savings in the hands of the richer sections. This possibility has given rise to a strong controversy regarding a choice between objectives of growth and equity. An equitable distribution, it is claimed, would place larger proportion of national income in the hands of poorer sections whose marginal propensity to consume is higher, and would therefore reduce the supply of savings. Likewise, it is argued, inequalities promote savings by placing a larger portion of income in the hands of people with lower marginal propensity to consume. We must however note that this conflict arises if the economy depends upon private savings only. A case can be made for an equitable distribution of income accompanied by requisite savings through public budgets.

Coming to direct taxes, let us first take up the case of a poll-tax. The discussion here may be divided into possible responses of different income groups. Very poor people are likely to reduce their savings, if any, when they are faced by a lump sum poll-tax. The response of the middle income people would partly depend upon the amount of the levy. A relatively higher levy is likely to result in a substantial reduction in their savings. The richer sections are not likely to reduce their consumption irrespective of the amount of levy (which cannot be very high for them because it would be fixed with reference to the average paying capacity of the community).

The discussion of a poll-tax, however, is mainly an intellectual exercise. Greater contenders in this field are other forms of taxes, especially income-tax and expenditure tax. The general argument here is that an expenditure tax is pro-saving. An income-tax discourages both earning of income and saving out of it. A higher income attracts greater tax liability, and a progressive income-tax more so. The result is that the marginal utility of income (after payment of an income-tax) falls faster with an income-tax and approaches marginal disutility of work at a lower income level. This fact in itself tends to reduce savings because savings come out of income. The very saving capacity of a poor country is smaller. Further, an income-tax discourages savings because if an income is used for current consumption, it does not attract further taxation. But, if it is saved, income from the saving would also be taxed. This reduces the rate of return on saving. The net effect on supply of savings would depend upon the income elasticity of savings on the one hand and the rate of taxation on the other. It means that the supply of savings would depend upon the responsiveness of savings to changes in net income which can be earned from them Taxation reduces

the net income from savings. Therefore for a given income-elasticity of savings, a higher tax rate, and for a given tax rate, a higher elasticity would mean a greater reduction in savings. An expenditure tax, on the other hand, taxes an income only when it is consumed. It does not penalize the earning of an income or a saving from it. One may talk about the uncertainty of the tax liability when the savings and income therefrom are consumed in future, but even then the superiority of expenditure tax over income-tax from the point of view of supply of savings stands.

If the concept of expenditure tax is extended to company taxation also, the expected stimulus to savings should be all the more. This idea has a special appeal for our country where we need an accelerated rate of business savings and capital formation. The fact that currently companies are taxed on the basis of their income tantamounts to taxing their efficiency. Income taxation penalizes a firm if it is economical and profit earning; but an inefficient firm making a loss is spared. In India, all expenses incurred for business purposes are deducted in the calculation of taxable income of a company. This encourages the companies to indulge in highly wasteful and unnecessary expenses. Another argument in favour of adopting expenditure tax in preference to income-tax is that expenditure taxation discourages capital intensive techniques. In our country, there is a large scale unemployment both in the urban and rural areas, while there is a shortage of capital. Expenditure taxation would help us in solving our unemployment problem. Furthermore, by adopting a structure of selective expenditure taxation in which high priority investments are exempted from taxation and low priority expenses are taxed more heavily, we can encourage investment into high priority industries which in turn may be expected to add to the pace of economic growth and productivity.

However, the above mentioned advantages of expenditure taxation cannot be fully reaped in our country. There are several conceptual and administrative difficulties in the way of its adoption, which make it not only impracticable but even harmful. Let us consider these difficulties in personal consumption expenditure taxation and business expenditure taxation respectively. If expenditure tax is determined with respect to total consumption rather than the type of expenditure, it becomes highly regressive. Therefore, expenditure tax on personal consumption, in our country, will have to provide an exemption limit on grounds of equity on the one hand and abject poverty of the masses on the other. Moreover, the rates of expenditure taxation would have to be progressive on grounds of

equity. Consumption of certain selected items would have to be left out of the coverage of this tax. But a personal consumption expenditure taxation with an exemption limit, selected coverage and progressive rates would make it administratively very difficult to implement. It would necessitate a highly elaborate and efficient accounting. In our country with large scale illiteracy, incomplete accounts and a good deal of barter transactions it is nearly impossible to set up an effective expenditure tax machinery. We are as yet not able to enforce even our income taxation which results in large scale tax evasion. The problems of tax evasion would be far more serious under expenditure taxation. Further, for an equal amount of tax revenue, the rates of expenditure taxation would have to be much higher. Coupled with the extent of possible tax evasion, it is likely to be very oppressive for those who are caught in the tax net. All told, under the existing conditions, a system of both indirect taxation and other forms of direct taxation appear to be better on grounds of our administrative capabilities, cost of collection and possible harassment to the consumers. Similar administrative and conceptual problems prevent us from realizing the advantages of an expenditure tax on companies. Thus, for example, it would be very difficult to decide upon the kind of company expenses which should be taxed. Inclusion of expenses on labour would militate against labour intensive techniques, paying them higher wages and other labour welfare measures by the employers. On the other hand, their exemption would tempt the companies (as at present) to incur unnecessary expenses for their highly paid executives. The problem of efficient accounts is not a major one for big companies, but it i nearly insurmountable in the case of small and cottage industries, shopkeepers and so on.

We may conclude this portion by adding a word about taxing of capital and its effect on the supply of savings. As seen above, capital taxation can be of various types. Ordinarily, such a tax would be expected to discourage the supply of savings, but this need not necessarily be so. In a rich economy, a certain proportion of national income gets saved because both companies and individuals would like to provide for the future and their marginal propensity to consume would be lower than in a poor country. Further, possible response of private savings to this taxation would depend upon its type, coverage, rates, the problems of evaluation of capital assets, the age groups which are affected and their attitudes towards provision for old age and future generations. To a certain extent, the supply of savings would also be affected by the allocative effects on existing

capital. There is no general conclusion here. The possible effect of each tax measure would have to be studied by bringing in all the relevant details of information. At the most we can make such statements as the one which says that if a capital tax leaves out non-income earning assets and covers income-yielding ones, it would tend to reduce future supply of savings by pushing the current savings into unproductive assets and retard the growth of national income and that it would be a powerful disincentive to save because people would like their savings to earn an income.

Let us now take up the question of *effect of taxation on supply of labour*. Here, as noted earlier, we would not go into analysis of the factors which determine the long-term supply of labour, instead, we would confine ourselves to the discussion of the supply of effort—that is the choice between work and leisure by a given labour force. For this purpose, we shall first consider a typical worker who has the option of choosing the length of his working day. Let us also assume that the wages are on time-rate basis so that longer working hours mean more wage income but less leisure.

The choice before our typical worker may be presented graphically (See Figs. 9.4 and 9.5). Hours of leisure per day (which can be at the most 24) are measured along horizontal axis and the corresponding earnings in rupees along vertical axis. The wage rate is Rs $\frac{OW_1}{OL_1}$ = Rs $\frac{OW_1}{24}$ per hour. Our worker can choose any combination of income and leisure along the earnings-opportunity line W_1L_1. Given the system of indifference curves with leisure and income, our worker would be at equilibrium at point E_1 (with leisure $=OM_1$ hours, work$=M_1L_1$ hours and daily wage income of Rs E_1M_1), when there is no tax imposed on the income of the worker. At E_1 his marginal rate of substitution between leisure and earnings is equal to the wage rate.

A poll-tax imposes a tax liability without reference to the level or source of income. The slope of the earnings-opportunity line remains unchanged, that is, the price (in terms of leisure) of earnings does not change. There is no substitution effect of the poll tax on the supply of labour. But it will have an income effect The worker has to meet this tax liability irrespective of his earnings. Therefore in order to make up this reduction in his income, the worker decides to put in more working hours In our diagrammes (Figs. 9.4 and 9.5) a poll tax of Rs W_1W_2 per day would push the earnings-opportunity line from W_1L_1 to W_2L_2. This would cause a reduction in income of our worker who would have to reduce his leisure from OM_1 to OM_3

and increase his working hours from M_1L_1 to M_3L_1. Out of his earnings F_3M_3 he pays F_3E_3 by way of a poll tax. Obviously, the new

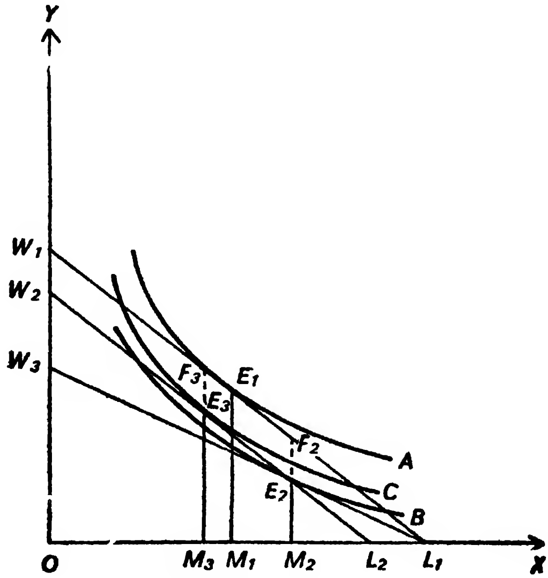


FIG. 9.4

equilibrium point E_3 would lie to the left of E_1 showing that on account of income effect, the labour supply had to be increased.

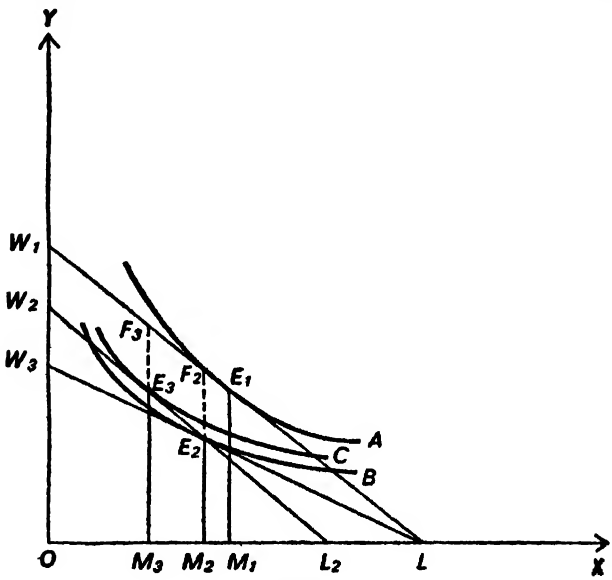


FIG. 9 5

A proportional income-tax implies a proportionate reduction in the earnings per hour of labour supply. In other words, this makes the leisure relatively cheaper while it costs more labour to get the same amount of income. A proportional income-tax at the rate of W_1W_3/OW_1 implies that the earnings-opportunity line is now W_3L_1. A proportional income-tax causes both substitution and income effects. The substitution effect, on account of relatively cheaper leisure and costlier (in terms of labour) income would tend to increase leisure and reduce labour supply. This is to say, it would push the new equilibrium point E_2 to the right of the line E_1M_1. The income effect would work towards an increase in labour supply and push the new equilibrium point E_2 to the left of the line E_1M_1. The net result would depend upon the relative strength of the two effects. E_2, therefore, can lie on either side of E_1.

If we assume that the government collects same amount of revenue from either of the two taxes (poll tax and proportional income-tax), then the equality between poll tax W_1W_2 and the proportional income-tax F_2E_2 would ensure that the post-tax earnings-opportunity lines pass through E_2 and the earnings-opportunity line W_2L_2 would intersect indifference curve B at E_2 and therefore the equilibrium point E_3 would lie at a higher indifference curve C and to the left of point E_2. Thus under poll tax the supply of labour is more than what it would be either under a proportional income-tax or under no tax.

In progressive income-tax, both average and marginal rates of tax increase with increasing income and the marginal rate rises faster than the average one. This means that at a given wage rate, as a worker works longer hours and earns more, the after-tax wage rate falls. This raises the marginal labour cost of earning an income. Therefore, the substitution effect becomes far stronger than it is in the case of proportional income-tax and this causes a greater reduction in the supply of labour. The strength of the substitution effect, amongst other things, depends upon the progression of income-tax and the wage rate. A greater progression and a higher wage rate would cause a greater reduction in labour supply. The income effect of a progressive tax would also vary with the level of income and progression in income-tax; but its relative strength compared with substitution effect cannot be assessed on *a priori* grounds.

Another variety of progressive taxation can be the one where there is an initial tax exemption followed by a proportional income-tax on the balance. In this case, the marginal rate of income-tax remains unchanged beyond exemption limit though the average rate

keeps on rising. Therefore in this case the substitution effect is the same as that in proportional income-tax and the income effect is also quite close to it. If, on the other hand, rates are progressive beyond exemption limit, the substitution effect becomes stronger, but the strength of income effect cannot be determined on *a priori* basis.

The preceding analysis is based upon certain unrealistic assumptions. We have assumed that a worker has the option of choosing his own working hours. This is generally not so. Also the fact that an income-tax may not be fully implemented would alter the above conclusions. In many cases there are possibilities of earning an income on which tax can be evaded. To the extent this happens, an income-tax would lose both the substitution and income effects. Therefore, the net effect on supply of labour would vary from individual to individual. Further, even if we agree that there is no tax evasion at all and the tax administration is able to cover all kinds of earnings including overtime etc. the income-enjoying capacity of different individuals and their attitudes towards leisure and earnings would differ. In technical terms, we may say that the elasticity of demand for income in terms of effort is not the same and the change in the supply of effort would depend upon whether this elasticity is equal to, greater than, or smaller than unity.

Let us now look at the *effect of indirect taxation* on the supply of labour. Indirect taxation, like direct taxation, reduces the real income of the labour. It is therefore claimed that both taxes would have the same income effect on supply of labour provided both taxes impose the same tax liability on each tax payer. However, this is an almost impossible task especially because it is difficult to tax services and we cannot precisely correlate the level of individual earnings with the pattern of individual consumption. Again, just as in proportional income-tax, the labour cost of earning a given real income goes up under indirect taxation also. It implies therefore that in terms of substitution effect, indirect taxation should cause as much reduction in the supply of labour as an equivalent-yield proportional income-tax. But here also this conclusion assumes that each individual attracts same tax liability in either tax system. It would be better, therefore, if we concentrate upon the possible effects of indirect taxation itself on the supply of effort without trying to compare them with those of direct taxation. For this purpose we should recognize the fact that certain goods are complementary to leisure so that a greater demand for leisure generates a greater demand for these goods also and vice versa. An example would be entertainment services. On the other hand, there are other goods and services which

are substitutes of leisure. Generally, indirect taxation would have a selective coverage of goods and services and at differential rates. Taxation of goods which are complementary to leisure would reduce their demand as also the demand for leisure and would encourage labour supply. Similarly, taxation of goods which are substitutes of leisure would reduce their demand and lead to an increase in demand for leisure and reduce the supply of labour.

The analytical method of classifying goods into substitutes of and complementary to leisure, unfortunately, has its own limitations at the level of practical policy formulation. It is not easy to have an unambiguous classification of this nature. Moreover, the authorities usually decide upon the taxation of commodities and the rates of taxation not with reference to their relationship with leisure and labour supply, but with reference to their elasticity of demand, their revenue potential and the income-level of people who consume these items. Similarly, while considering the levying of indirect taxes and their rates, the authorities might distinguish between consumption goods on the one hand and raw materials, intermediate goods and capital goods on the other. It should also be emphasized that in the case of indirect taxes, in the above analysis, we have implicitly assumed that the price rise in a taxed good is equal to the tax amount. However, the interdependence of various goods in terms of complementarity and substitutibility as also the monopolistic practices of the producers and sellers often cause a change in commodity prices which is far removed from the tax levied. Very often, the price rise is not limited to the initial impact of an indirect tax. The price rise may be in several rounds and far in excess of the tax imposed. We have seen above that such a price rise redistributes national income against wage income. This should cause an income effect stronger than the substitution effect and cause a net increase in labour supply.

TAXATION AND DISTRIBUTION

This brings us to the effect of taxation on distribution of income and wealth. It must be remembered that market mechanism by itself generates a good deal of income inequalities and they get further strengthened through the institutions of private property and inheritance. One important objective of the fiscal policy of a modern government therefore happens to reduce the income and wealth inequalities. However, this egalitarian objective is likely to come in conflict with that of increasing production and economic growth.

Here we might break up the problem into two parts, short-term and long-term. In the short-run, it may be stated, any income and wealth distribution pattern can go in harmony with the production level in the country. Thus it may be assumed that the total national product is already there and that now the problem is to determine the individual shares of the members of the society. Definitionally, therefore, this stand makes distribution independent of its effects on production. Such a redistribution of income, therefore, may be brought as close to equality as we like through various tax measures. However, we must note the following points in this connection.

Firstly, unless there is a total political and economic revolution in a country, a quick redistribution of income and wealth is not a possibility. The process will be a time-consuming one if measures like progressive income-tax, wealth tax, gift tax, expenditure tax and the like are to be used. So long as the institutions of private property and inheritance are there, the process towards equality will be a bit slow one This implies, therefore, that in reality, a proper degree of redistribution might be expected only in the long-run. In the long run, however, any policy directed at reducing the inequalities is likely to have its repercussions on production also. *Secondly*, even if it were possible to reduce the inequalities to a desired extent in the short-run, such a policy would have its long-term repercussions which should not be ignored. An economy does not live only for today. Along with the society, it is expected to be a perpetual one. *Thirdly*, in an underdeveloped country like ours, use of taxation for reduction in inequalities of income and wealth has its own limitations. Direct taxation, with all its progressive rates, covers only a fraction of the population. The incidence of tax evasion further aggravates the ineffectiveness of direct taxation in this direction. Indirect taxes, on the other hand, cannot be progressive enough in spite of their selective coverage and differential rates. And since indirect taxation itself is inflationary in character, it works towards increasing inequalities. Possibility of evading excise and sales taxes would further strengthen this process.

In the long-run, a reduction in inequalities brought about by taxation might be counterbalanced or more than counterbalanced by other forces such as increasing inequalities in the pre-tax incomes of the members of the society. If, therefore, this possibility is to be eliminated, then it is essential that not only taxation should be sufficiently steep so as to practically mop off the incomes beyond a certain height, but that tax evasion should be made impossible. Steep taxes designed to reduce the concentration of wealth and economic power

would have to be there and implemented effectively.

Steps towards reducing inequalities will have different possible effects on production and growth. If the progression of taxes is relatively mild or not so steep, adequate incentives will be left for every one to work hard and contribute towards economic growth. Thus, one acceptable objective before the authorities can be that of not permitting the relative inequalities to grow and reduce them gradually over time. This may be done through various progressive tax measures (and of course public expenditure devices also) touching on income, wealth, gifts, inheritance, windfalls, capital gains etc. Allowing adequate incentives for producers in the private sector to progress, and expanding public sector profitability and savings at the same time, should be pursued in a balanced and harmonious manner. In other words, enough of economic incentives should be there in the economy to edge the members of the society to work hard and produce more. However, taxing gifts, unearned increments and capital gains at very steep rates will not reduce the incentives to work and earn because these taxes touch upon those receipts which are not coming out of economic efforts of individuals. Wealth tax and inheritance tax, however, can become a disincentive to save if the rates are too steep.

Thus, if income and wealth inequalities are sought to be reduced through tax measures, there is bound to be a conflict between this objective and that of growth. Either, therefore, the State has to abolish the institutions of market mechanism, private property and inheritance and take over the task of economic growth upon itself, or it has to leave a required degree of incentives in the economy. The latter course, however, necessitates a determination of the required degree of progression for this purpose. It is a difficult but necessary choice if the society is not to opt for the first alternative. In an underdeveloped country, such a conflict between egalitarian and growth objectives is all the more sharp because there is an immediate need for both. There is abject poverty in the masses which should be reduced to some extent at least. But a final solution of it can come only through economic growth, otherwise an equality without adequate production would only amount to distributing poverty. In a developed country, on the other hand, since even the poor are not so poor in absolute terms, the objective of equality could possibly be postponed At the same time, those countries are not faced with an immediate problem of economic growth and so they can afford to go ahead with distribution. Accordingly, in such countries the tendency is usually to emphasize redistribution but in such a way that the economy is not pushed to stagnation or decay and the normal forces of growth

(which have already been released) are allowed to operate.

TAXATION AND ECONOMIC STABILIZATION

A market economy, given sufficient freedom, will exhibit a strong tendency to have trade cycles and there will be recurring phases of rising and falling incomes, output, employment and prices. Various explanations have been given for this phenomenon, but it is now generally recognized that the availability of purchasing power in general and speed with which it is used are important variables in the total behaviour of a trade cycle. During the rising phase of the cycle, the quantum (and the speed of its use) of purchasing power will increase and will thus add to the total effective demand in the country. Just the opposite will happen during the downward phase of the cycle. Another usual feature of changing effective demand is that its expansion or contraction is not evenly distributed over all the sectors of the economy and as a result some of these sectors are under greater inflationary (deflationary) pressures than others.

The older philosophy of *laissez-faire* favoured the absence of any action on the part of the authorities to correct the trade cycle. As in many other areas, it believed in the existence of inherent corrective forces within the economy to which the tax system of a country would contribute as a stabilizing force. Thus during the upward phase of a cycle, there is an all-round increase in prices and economic activities. This brings in greater tax revenue to the authorities in both direct and indirect taxes. In case the tax system is progressive, the addition to tax revenue would be still faster. Assuming that the public expenditure remains unchanged or rises much slower, the government budgets would show a surplus. They would cause a leakage from the expenditure flow in the economy and would be contradictory in effect. Similarly, it can be argued that during the downward phase of a cycle, taxation would act as a stimulant to the economic activity. Thus taxation was believed to be a built-in stabilizer.

But the Great Depression of the 1930's changed the outlook of both the authorities and the academicians. Keynes, for example, showed how a developed market economy was not able to defend itself against a persistent deflationary tendency on account of a deficiency of effective demand which in turn was caused by falling marginal propensity to consume and falling marginal efficiency of capital. He, therefore, suggested various remedies to push up expenditure in the country. Lerner, similarly, came out with his concept of functional finance in which the State was not to worry about the surplus

or deficit budgeting as such. It was to keep in mind the role of both taxation and expenditure so as to correct the market incompatibilities between demand and supply. From Keynesian framework of analysis we can derive the general prescription that a progressive taxation should be of help in neutralizing the fluctuations in the economy. Such a tax system will not be taxing the poor heavily and since the poor have a high marginal propensity to consume, there will be a firm base of aggregate consumption in the country. Furthermore, with depression, the tax liability of the richer sections would fall rapidly, thus, leaving a relatively larger proportion of purchasing power in the private hands. During inflationary periods, on the other hand, the tax liability (especially of the richer sections) will increase and thus excess purchasing power will be drained away. The authorities were to supplement the corrective measures by adjusting the public expenditure also, raising it during a depression and reducing it during the boom. While Keynes was basically emphasizing the remedial actions against depression only for reasons of his own, Lerner highlighted the utility of functional finance in combating inflationary tendencies also.

The above Keynesian analysis and the functional finance approach assume competitive markets and run in aggregate terms. They emphasize that there is no inherent virtue in the system of balanced budgets and that the state may go in for a cumulative addition to public debt on account of repetitive deficit budgets. We may add the fact that public budgets cannot be neutral even in their aggregate effects. For example, even a balanced budget has a multiplier effect (*See* Chapter on Balanced Budget and Fiscal Policy). And this leads us to the refinements associated with viewing the tax system in its disaggregative form. Thus, for example, it is sometimes stated that in order to curb inflationary forces taxation should be increased. Here, however, we must distinguish between the roles of direct and indirect taxes. Indirect taxes are superimposed upon the cost of production. Accordingly, if the taxed goods have a high elasticity of demand and low elasticity of supply, a greater part of their incidence gets settled on the suppliers themselves. This reduces their profits and has an effect of checking inflation. Thus we must remember that the goods having a high elasticity of demand and a low elasticity of supply are not likely to show much of inflationary tendencies. It is precisely those goods which have a low elasticity of demand and high elasticity of supply where inflationary forces are able to exert greater pressure. If indirect taxes are imposed on such goods, their incidence will be shifted on to the buyers. And this type of pheno-

menon feeds the forces of inflation. If the taxed goods are of consumption variety, they would raise the cost of living and will force the workers to demand higher wages. In due course, to the extent that wages rise, cost of production in industries producing even untaxed goods will rise. This would entail a further increase in the cost of production of those industries which are getting their imputs from the high cost industries. About the same thing would happen if taxed goods are straight-away inputs of other industries. The self-feeding process of inflation would gather strength with the passage of time. If, therefore, inflationary forces are not to be helped through indirect taxes, a judicious choice will have to be made both in the commodities to be taxed and the rates of taxation. Luxuries may be taxed, but not necessities which will raise the cost of production all round. Similarly, wherever the taxes are likely to touch necessities or essential inputs, the rates should be quite low. Foreign trade is an important medium through which an inflation or deflation gets transmitted from one country to the other. An appropriate use of customs duties in harmony with the elasticities of demand and supply of the relevant goods is a potential tool for insulating the domestic economy from trade cycles originating abroad.

10 PUBLIC DEBT

THE MEANING OF PUBLIC DEBT

Public debt has been defined in several different ways depending upon the purpose of the definition and the type of institutional arrangements of a country. Thus, on the one extreme, all kinds of obligations of a government (including the currency obligations) are included in public debt and on the other, quite narrow definitions are also adopted. There are also inter-governmental obligations—such as loans from the Central Government to the States—about which a decision has to be taken. The central bank of a country may also be considered a part of the government for the purposes of estimating the volume and composition of the public debt, or it may be taken as one of the private economic units in the country.

It will be helpful if we have a brief idea of the type of obligations which the government of a country usually incurs. *Firstly*, there is the *currency* itself. In many cases, however, the government creates only a part of the currency; the rest is created by the central bank of the country. Thus, technically speaking, all the currency issued by the authorities of a country may not be the obligations of the government itself. If, however, we consider the central bank as a part of the government sector owing so much to the private sector of the economy, then of course, even the central bank currency is a part of the over-all currency obligations of the government. These currency obligations, however, normally remain dormant or inactive and the government does not 'pay off' its currency obligations—at the most one set of currency is replaced by another set and that is all.

Another set of obligations may be called the *short-term debt*. Such obligations are normally of a maturity of less than one year at the time of issue and consist of items like the Treasury Bills, Treasury Deposit Receipts, and borrowings from the banking sector for a short period. There are some obligations which are referred to as the *floating debt*. Such debt may not have any specific maturity, but part of it may be repayable subject to various terms and conditions. For example, there are items like the provident funds, small savings, reserve funds and deposits, and so on. In India, the Government of India has also issued certain special securities to meet its obligations

towards international institutions like the International Bank for Reconstruction and Development and the International Monetary Fund. These special securities may be called *special floating debt.*

Another important category of government obligations consists of the *permanent* or *funded* debt. Such loans have a maturity of more than one year at the time of issue. Some of them may even be non-terminable (perpetuities) so that the government is only to pay the interest on such debt, but not the principal thereof.

The above-mentioned obligations, to some extent, may be to the foreigners—governments, institutions, firms and individuals. Such foreign obligations are called *external loans.* It would be seen that these external loans could belong to many of the categories of obligations mentioned above.

It should be clear by now that depending upon the purpose and context, institutional arrangements, and so on, different people could define public debt differently. On the one extreme all obligations of the government including the demand debt are sought to be included in the definition of public debt, while in other cases only some of the above-mentioned categories of obligations are considered. In general, however, the demand debt of the government is usually excluded from the definition of the public debt and only the floating, funded and other obligations are considered as the items belonging to the public debt proper.

PUBLIC DEBT AND PRIVATE DEBT

In certain respects government borrowings resemble the private ones. Like a private borrower, the government may also borrow either for consumption or for investment purposes. It will also be paying interest on such borrowings. But the dissimilarities between the two are more glaring. A private economic unit cannot borrow internally, that is to say, it cannot borrow from itself. The government usually borrows internally, that is from its own subjects and from within the economy. But a more important difference is that while a private economic unit can repay its debt either out of its earnings or out of its accumulated assets or by borrowing from other sources (thus substituting one debt for the other), such need not be the case with the government. The government is the creator of currency and can pay its debt straightaway by printing more currency. The fact that it usually does not do so only reflects its concern for the welfare and stability of the economy and not the lack of its power to print more money and pay off its debt. External debt (that is the debt owned by

the foreigners) may not, however, always be payable in this form. If the debt obligations are in local currency, then this is a feasible step. But if the foreign loans are repayable in foreign currencies, or gold, then the creation of currency cannot be the means of repaying those loans. In that case, foreign currency will have to be procured through export earnings or some other means, or gold will have to be paid out. Still another important difference between private and public borrowings is that public borrowings have a profound effect on various dimensions of the economy—distribution, capital accumulation, economic growth, income and employment stability, and so on. This way public debt is both a source of problems and a tool of economic management in the hands of the authorities.

Why Public Debt?

Let us now see the reasons on account of which a government might incur public debt:

(1) The first reason for a government running into a debt is the fact that like any other economic unit, a government (including its constituent units) has to engage itself in collecting revenue and spending it. However, it is hardly likely that from period to period the inflows will match the outflows. There can be periods when receipts will exceed the expenditure and vice versa. Of course, unless the government is having a *policy* of spending too much or too little compared with the receipts, the two will tend to be equated. In other words, the deficits and surpluses will tend to counterbalance each other so that over a longer time there will be a tendency for the budget to 'balance.'[1] This used to be the general policy of governments in olden days, namely, the policy of having balanced budgets. Deficits, then, were expected to be temporary to meet various emergent needs. Within a year, for example, during some lean months there would be a deficit and the government would be borrowing from the market or would run down its cash reserves. And during the busy months of the year, on the other hand, the deficit will be wiped out.

(2) The second set of reasons could be those which could cause a sudden spurt in government expenditure. There could be wars, or natural calamities in which case the government would be committed to a much larger expenditure and would therefore run into a debt. But this type of debt also was expected to be repaid as early as possible through subsequent surplus budgets.

[1]Unevenness of the receipts and expenditure flows will, therefore, create only short-term loan obligations of the government.

(3) This philosophy of trying to avoid a surplus or a deficit budget, at least in a persistent manner, has given place to a new philosophy—that of functional finance. According to this approach, the government does not have to worry about a surplus or a deficit even when it is a persistent one provided such an 'imbalance' is needed for correcting the market behaviour and bringing about economic stabilization. The traditional philosophy was the result of a few ideas at work then.

Firstly, the history of the governments raising loans was not a happy one. Loans had quite often been raised by rulers for waging useless and expensive wars, for squandering them away on conspicuous consumption and for other wasteful expenditure. The authors of those days were therefore sceptical about this practice of raising loans and having deficit budgets. It symbolized a kind of wasteful and irrational expenditure which could be avoided.

Secondly, the belief in *laissez-faire* also dictated that the authorities should avoid undue interference in the working of the market. Raising loans and spending them was not likely to contribute towards this.

Thirdly, such government loans were considered akin to private loans. Just as private loans have to be cleared eventually, it was believed that public loans also have to be. We know that public loans need not be fully paid. Maturing loans may be replaced by new ones by either conversions or through cash subscriptions. Also some loans may be perpetuities.

(4) With the thinking that the government of an underdeveloped country should play an active role in the development of the economy, the philosophy of having a balanced budget is further eroded. Now a budgetary policy is supposed to be an important and effective tool in accelerating the process of capital accumulation and economic growth. This may be done through borrowing and investing those funds in various projects. Loans might even be specifically raised for certain projects.

It is sometimes erroneously concluded that when a government adopts a deficit budget, it automatically adds to its debt. This is not necessarily so. Actually, when a government incurs a deficit, it can meet this deficit by the following means:

(*a*) It can run down its cash reserves,

(*b*) It can sell some of its assets like properties etc.,

(*c*) It can print more currency and use it, or

(*d*) It can borrow and spend.

Now it is seen that the second method of meeting the deficit does not at all increase the indebtedness of the government, though a

government seldom adopts this approach. The first and third methods increase the supply of currency of the government in the market. Whether or not public debt increases depends upon our inclusion or exclusion of currency obligations in the definition of public debt. Then, there is the fourth method. Here again there are two varieties. The government may borrow from the market proper or it may borrow from the central bank. Borrowing from the market will obviously increase the outstanding public debt. Borrowing from the central bank increases the government's indebtedness to the central bank and the central bank, in turn, issues more currency to the public. The mechanism, in simple terms, is as follows.

When the government borrows from the central bank, it hands over or 'sells' its securities to the central bank. The central bank 'pays' for them by making credit entries in favour of the government in its books. Now if the central bank is considered a part of the market, public debt has already increased by the borrowed amount. When the government spends out of its balances with the central bank, the central bank issues currency to the public and makes debit entries against the government. If the central bank is considered as a part of the government and the currency is not considered as a part of the public debt, then no addition to public debt has taken place. Generally, however, as noted above, currency is not considered as a part of the public debt, but the borrowings from the central bank are considered a part of the public debt. To put it in other words, it is the non-currency obligations of the government which are considered as the public debt. A part of such debt may be held by the central bank of the country for various reasons. This fact and a possible variation in these holdings can be used, as we shall see, as a part of the over-all economic policy.

Some Terms

Before we take up various theoretical and policy issues connected with the public debt of a country, it might be useful to get familiar with some of the important terms usually used in relation to public debt.

Public debt may be *internal* or *external*. When it is owned or held by the subjects of the indebted government, it may be called an internally held debt. In this case, the community owes this debt to some of its own members. The debt will be external if the creditors are foreigners in which case its servicing and repayment will mean a drainage of national resources in favour of those foreigners. It is clear that if there is sufficient freedom for loan obligations to change

hands, there may be a shift as between external and internal loans. Furthermore, it is usually the central government of the country which is authorized to raise loans externally. Similarly, if loans can be sold by the existing holders to others, they would be called *marketable*. *Non-marketable* loans are those which have been issued in favour of particular debt holders only and cannot be sold to others.

Government loans may be *interest-bearing* or *non-interest-bearing*. To begin with, there are two types of interest-bearing loans. In the first category, a loan carries what is called a *coupon*. The holder of such a loan is entitled to a given interest payment periodically, say every six months. Most funded loans are of this type. The second category is where a loan is sold below its redemption value—at a *discount*. In India, for example, treasury bills are sold that way. A treasury bill has a maturity of thirteen weeks at the time of issue and may be sold at a price of say, 99% of its redemption value. It means that the buyer will purchase a treasury bill (having a redemption value of Rs 100) for Rs 99 and after three months will get Rs 100. It is, thus, equi.. lent of an interest of Re 1 on Rs 99 for a period of three months Some loans, however, do dot bear interest at all and are called non-interest-bearing. There may be, for example, prize bonds, certain deposits like earnest money for tenders, and so on. Some interest-bearing loans, having reached their maturity date or having been recalled for repayment, may still be outstanding. They cease to bear interest after the stipulated date.

It must be noted that there are two aspects of interest on government securities. The first is, as noted above, that a government security carries a coupon or is sold at a discount. In either case the government is committed to a given interest payment (in absolute terms). The coupon or discount at which the government is able to issue a loan will depend upon the circumstances in the market—the general level of interest rates, whether the market is having a lean or a busy period, the general conditions regarding the availability of investible funds, and so on. In general, however, the government is able to borrow at rates much lower than the ones prevailing in the market mainly because of its creditworthiness. The creditors of the government have a faith in its solvency and will to pay the loans and interest instalments when they fall due. Of course, the government does not pay the same interest on each loan. At the time of issue, usually the shorter maturity loans carry a lower yield than the longer maturity ones.

The second aspect is that though the government's obligations are fixed in absolute terms, the effective rates of return on government

securities fluctuate. If the market rates of interest move up, the government security prices fall so as to yield higher rates of return to those who might buy them now. Security prices will similarly rise when the market interest rates fall. This phenomenon of interdependence between the market interest rates, coupon rates, maturity composition of the securities and their market prices can be used by the authorities, if they so desire, to influence the market behaviour. We shall look into this problem later.

Another classification of public loans into *productive and unproductive* ones is, however, a nebulous one. A loan would be called productive if it gives rise to income yielding assets or project(s). This classification is nebulous because firstly loans may not be earmarked for particular projects. Quite often the government would just estimate its total needs and examine the expected revenues, and decide to raise loans. No particular loan would go into any particular asset as such. Secondly, the government might be spending the loan-amounts on those items which are not creating new sources of revenue for the government but which are otherwise highly productive for the economy. For example, if the government spends on education and thereby increases the productivity of the country's labour force, or spends on roads and bridges and thereby improves the productivity of the industries, we cannot call such loans unproductive simply because no corresponding revenue yielding assets have been created. Even raising loans for fighting a war might be helpful for maintaining or augmenting the productive strength of the economy. Instead of, therefore, labelling various loans as productive or unproductive as such, it would be more useful if a general examination of the government expenditure policy is made and useless and unnecessary expenditure is curtailed.

Limits to Raising Public Debt

We find that in most countries public debt has shown a continuous upward trend during the last few decades. As seen above, there have been various factors contributing to it. But, in this context, a question arises as to whether there is any definite limit beyond which a government cannot increase its public debt. To answer this question, we should distinguish between the will and capacity to raise loans on the part of the government and both these should be considered in the context of short-run and long-run possibilities.

It must be remembered at the outset that a modern government would not resort to borrowing for the sake of it. It does not have a tendency to borrow and squander it away on wasteful consumption

to suit the whims of a section of the rulers etc. It will borrow for only such consumption purposes which are considered absolutely necessary for the economy such as for defence, protection against natural calamities, certain other welfare activities, and so on. In normal circumstances, the government of a country might borrow as a part of its anti-cyclical operations (that is with the objective of stabilization), while in an underdeveloped country it may borrow for capital accumulation and economic growth. These days, one self-imposed limitation by the governments is that the borrowings must be for public purposes. And in some cases, even specific legal restrictions may prohibit the government from borrowing under certain circumstances or beyond certain limits.

A government finds that in the short-run, if it wants to borrow more, it has to raise the interest payments on its debt. Government borrowings will reduce the supply of funds available to the private sector of the market and therefore a higher interest rate will emerge on account of such general shortage of funds. The interest offered on such government loans will be raised in order to attract subscriptions to the loans and conversions of the old ones. This higher interest cost will act as a deterrent for the authorities to borrow too much and unnecessarily. If the government is in need of large-scale extra finance, such as during a war, then it may adopt some other methods to keep the interest rates low (that is follow a policy of cheap money). Since the short-term loans carry lower rates of interest, the government could lay much greater emphasis on those and keep its interest cost low. At the same time, in an emergency like war, the government is likely to resort to the printing press which not only adds to the currency supply but also to the over-all credit creation in the country. Simultaneously, to keep 'non-essential' demand under check, the government would be imposing various controls and thereby make the excess purchasing power ineffective. This implies that the market will have surplus funds to invest and the authorities can borrow them.

In the long-run, the situation is quite different. Total volume of public debt can increase gradually in harmony with the growth in national income and credit structure. Therefore, no definite limit may be stated to exist for the volume of public debt in the long-run (unless the law sets such a limit). To say, for example, that total public debt should not exceed a certain proportion of the national income has no definite relevance unless the law of the country imposes such a limitation. Furthermore, the borrowing power of the government can be assumed to be unlimited in this context. The authorities need

not pay the older debt—it can just be renewed and some of it can be even converted into perpetuities—and every year some amount can be added to it through new loans. Also the philosophy that the government should not worry about the actual deficits but should keep in mind the over-all economic requirements of the economy frees the governments from its inhibitions to let the public debt exceed a certain limit.

These days another line of thinking propounded by Gurley and Shaw and the Radcliffe Committee emphasizes an important role of public debt in the economy of a country.[2] According to Gurley and Shaw approach the physical growth of an economy cannot be sustained without a corresponding financial growth. Financial growth, to be healthy and strong, necessitates the growth of the public debt also since this forms the base of the superstructure of the credit system in the country. With the economic growth, therefore, it is essential that credit base of the economy in the form of public debt should also grow. The Radcliffe Committee emphasized the role of public debt as a powerful tool in the credit and monetary regulation of the economy.[3] This line of thinking has been subsequently advocated, elaborated and emphasized by many writers.

Public Debt and Economic Growth

A. *Contribution to the Financial Structure of the Economy*. An important feature of economic growth is the fact that an ever-increasing proportion of the economic activities get monetized. In other words, these economic activities of production, consumption, distribution, trade etc., develop their financial counterparts resulting in corresponding financial transactions also. As a result the financial requirements of the economy increase both absolutely and in relation to the national income. Significant developments take place in the composition of financial structure also. Because of inevitable unevenness of the flows of receipts and expenditure of individual economic units, a need for credit system grows and a variety of credit instruments comes up. The total credit structure may be divided into two parts viz. 'inside money' and 'outside money.'[4] Inside money refers to the loans and financial claims against the private sector of the economy while outside money refers to the financial claims against the government sector.

[2]Gurley and Shaw, *Money in a Theory of Finance*, 1960.
[3]Radcliffe Committee (Committee on the working of the Monetary System), *Report*; Cmnd. 827, Her Majesty's Stationery Office, Great Britain, August 1959.
[4]Gurley and Shaw, *op. cit.*

Now the government obligations form an acceptable and sound base for the private credit structure also. The variety of government loans—in terms of maturity dates etc.—provide an ample opportunity for the financial institutions and financial markets of the economy. The government obligations do not have to be only currency obligations in which case their role will obviously be stunted.

If, therefore, the physical economic growth of a country depends upon the strength, development and health of the financial structure of the economy, the latter in turn must have a wide, varied and acceptable base to stand on. Credit being ultimately an expression of confidence, the best base could be only the government obligations. There is no risk of default in their case and they have a ready marketability. And these qualities are not found in as much measure in private debt obligations. Even if they were, it is unlikely that there could be a sufficient supply of these sound and acceptable private claims so as to form a solid and firm base for the private credit superstructure.

As a country advances, quite a few banking and non-banking financial intermediaries come up. They contribute to the institutions, arrangements and mechanics of effecting and collecting the community's savings and channellising them to various uses. In the process they also contribute to the development of the credit structure of the economy by adding their own debt obligations to the system. Banks, for example, are well known for their credit creation. In the market, therefore, a lot of claims and counterclaims come up which have to be sustained through a confidence in the ability of the debtors to meet their liabilities. The private claims are therefore often backed by public debt holdings.

B. *Contribution to the Saving Effort of the Economy.* An underdeveloped country is characterized by a shortage of capital resources which need to be remedied through increased saving and investment. The economy being poor and the saving capacity of the masses being very low, this task cannot be left in the hands of the people as such. Of the various measures which the authorities might take, one is that of resorting to public borrowings and investing the same. Let us assume that public borrowings are used for the development of capital goods sector or for the development of social overheads and that these funds are not used for addition to the consumption by the authorities. Now these borrowings may be divided into two parts: (1) borrowings from the market proper, and (2) borrowings from the central bank. In each case the effect on the economy will be quite different.

(1) In the case of borrowings from the market, the net effect on

savings and capital accumulation in the country will depend upon the source out of which market borrowings come. Thus, one possibility could be that the public reduces its own consumption and contributes its savings to the public loans. In this case there will be obviously a net increase in the speed of savings and capital accumulation. However, it is highly unlikely that the people will *voluntarily* save more under the temptation of an interest income. This is because the common man in an underdeveloped country is very poor and cannot easily reduce his consumption which is already very low. Actually most savings are effected only by the richer sections and firms from whom the contributions to public loans should be expected. Here, however, the danger is that the savings which would have gone into investment on private account would be diverted to public loans. If that happens, then there would not be any net increase in the saving and investment activity. But public loans will generate *reallocative effects*. Public investment is likely to be in the capital goods sector while private investment tends to concentrate in consumption goods sector which happens to be more profitable. Public loans, in other words, will help the economy in its growth effort through shifting the employment of its resources.

(2) When the authorities borrow from the central bank of the country, the effect is equivalent to resorting to the printing press. By printing additional currency, the authorities add to the demand forces in the market, causing an upward pressure on prices. A part of the supplies is purchased away by the authorities by spending the newly created money and the market is left with smaller supplies. Similar is the effect when the authorities borrow from the central bank. However, this process of forced savings and capital accumulation is not always a desirable one since it can lead to all the harmful effects of inflationary rise in prices.

Public Debt and Inflation

The above considerations lead us to the relationship between public debt and inflation. Most governments while raising loans for their investment and even for consumption purposes, will claim that such an activity is not going to add to the inflationary forces. They claim that the market borrowings are diverting funds from the market into the hands of the government and they are spent by the government instead of by the market. Thus, according to this logic, there is only a diversion of demand, but no net addition to it.

This reasoning is quite misleading because it tries to hide some of the basic facts. *Firstly*, even if public debt only brings about a diver-

sion in demand, it is bound to be inflationary in character because the economy's resources will be diverted from the production of consumption goods into those of capital goods. By their very nature, investment goods have longer gestation periods and therefore for the intervening period, the demand for consumption goods tends to exceed their supply.

Secondly, a government may include its borrowings from the central bank in the category of 'market borrowings,' if the securities sold to the central bank are long-term ones. This is done in India. A sizeable portion of the Government of India funded and marketable debt is owned by the Reserve Bank of India. Such borrowings from the central bank, we have seen, are not equivalent to a diversion of demand, but a net addition to it.

Thirdly, in an underdeveloped country, a sizeable portion of the public debt is likely to be owned by the commercial banks. The commercial banks consider their holdings of government securities as a good investment which can be encashed at any time without much of capital los. This assured liquidity position, therefore, tempts them in increase their loans and advances and thus add to the inflationary pressures in the market.

The above-mentioned forces point out that the 'market-borrowings' by the government can be inflationary due to various reasons. However, in the long-run, there can be counteracting forces also. Inflationary pressures ultimately reflect the excess of demand over supply. And if therefore in the long-run public debt is used to bring about increase in the productivity of the economy leading to an increased supply of the demanded goods, inflationary forces would be checked to that extent. Borrowings used for war activities, for meeting natural calamities and for other relief measures are most likely to be inflationary in their impact because they are basically consumption-oriented. In such situations, the authorities will generally resort to price-controls, rationing and other measures to keep the prices under check.

Public Debt as a Means of Regulating the Economy

Through variations in the volume, composition and yield rates of public debt, the financial markets in the economy can be influenced and regulated in terms of the desired objectives. In itself also, public debt forms a major portion of the total supply of credit and the above-mentioned variations in it lead to corresponding variations in 'liquidity' of the economy. As Radcliffe Committee emphasized in its

Report,[5] public debt forms a significant portion of the total credit supply in a country, and is therefore, intimately connected with the working of the economy. Changes in the volume and maturity composition of public debt will themselves affect the liquidity position in the market and will cause changes in the volume and composition of market demand. A lengthening of the maturity composition of public debt should be expected to reduce the over-all liquidity of a given amount of public debt, while a shortening of the public debt maturity will have the opposite effect. The authorities therefore can swap longer maturities with the shorter ones and vice versa as a matter of policy. In the process they will be additionally affecting the yield structure on the public debt and other financial assets. The emphasis given by the Radcliffe Committee on the public debt as a tool of economic policy has been widely debated in economic literature. There are of course differences of opinion as to the exact margins by which variations in public debt would affect the yield structure on public debt and the yield structure on other financial assets.

Any one who owns some public debt possesses a purchasing power which can be quickly and easily converted into spendable purchasing power. Therefore, through various public debt policies the authorities can directly influence this totality of purchasing power or 'liquidity' of the public debt. For example, an addition to the total volume of the debt should mean an addition to the total liquidity. Such an addition however will be less than proportionate increase in the volume of the debt because public debt is an imperfect substitute of money (so that additional debt will be able to do the job of a smaller amount of additional money) and because a minimum amount of money is anyway needed (which means that debt cannot fully remove the need for the use of money). Similarly, it is generally agreed that short-maturity is a closer substitute for money because it carries a smaller capital risk. Its price does not deviate much from its redemption value. Longer-maturity debt, on the other hand, is relatively less liquid. Accordingly, by changing the maturity composition of outstanding debt in the market, the authorities can again change the over-all supply of liquidity of the public debt. The exact way in which, of course, changing liquidity will affect the demand patterns etc. is a matter of investigation.

Since public debt forms a base for the private credit structure of the economy, therefore, it can be used quite effectively for that purpose

[5]Radcliffe Committee, *op. cit.*

also. For example, through open market operations and therefore by changing the volume of outstanding debt in the market, the banking credit can be influenced. Similarly, by bringing about a downward or an upward pressure upon the yields of the government securities, the authorities can hope to influence the market rates of interest also, which in turn will influence the market value of various financial and real assets. Changing values of these assets are bound to affect the demand and consumption volume and pattern in the economy.

Now the exact way in which, and the exact extent to which, changes in the interest rate structure and the volume and composition of public debt will affect the volume and composition of the demand flows, investment and other decisions in the economy are a matter of empirical investigation. But that such an influence is there cannot be doubted. However, some general tendencies can certainly be stated. For example, it is very likely that an increased supply of liquid purchasing power will push up demand and (if the supply does not rise fast enough) prices also. A fall in the supply of liquidity should similarly discourage demand and prices. In the same way, when interest rates go up, investment activity will be checked unless inflationary pressures have raised the expectations of rising prices too much. Falling interest rates should have the effect of encouraging investment activity. Higher interest rates, moreover, tend to push down the values of the assets both real and financial and this had a dampening effect on both consumption and investment. Lower interest rates on the other hand induce extra expenditure in the economy.

These tendencies can be used to devise a debt policy which will be anti-cyclical in effect, and will therefore contribute towards economic stability. During the boom period, for example, over-all supply of liquidity should be reduced. Now one way of doing this is to reduce the supply of the public debt in the market. But since money is a substitute for public debt and is more liquid, care should be taken that in the process money supply in the market is not increased. Actually if a part of the existing money supply could be replaced by public debt, total liquidity will fall. This is sought to be achieved through sales of securities in the open market operations. If, however, the supply of debt could be reduced without corresponding increase in the supply of money, then it would have been all right. Similarly, within the given volume of public debt, the maturity composition could be lengthened, and particular interest rates (or yields) could be raised. While combating a depression, similarly, the modus operandi would be to increase the total supply of liquidity. This may be done by simply adding to the money supply, or adding to the public debt,

replacing public debt with money supply (through open market operations) and reducing the general level of interest rates.

It would be noticed that anti-cyclical debt policy must work in harmony with the monetary policy of the country. In open market operations, for example, it is mostly the sale and purchase of public debt that is involved and through that the over-all credit supply is also sought to be regulated. If, however, the debt management policy aims at objectives other than economic stabilization, the two policies can come into conflict with each other. Thus, for example, the authorities may be interested in reducing the interest cost of their debt to the minimum. This will mean that during the depression when interest rates are low, they should raise the loans and should also convert the existing short-term loans into long-term ones, at the same or lower interest rates. By borrowing from the market they will be replacing the money supply with the public debt and that will reduce the total supply of liquidity in the economy. A shift towards longer maturities in the public debt will have the same effect. Monetary policy, on the other hand, would indicate the need to increase the supply of total liquidity. Similarly, there can be other areas of conflict between monetary and debt policies.

Public Debt *versus* Taxation

The merits and demerits of debt and tax finance are often debated. It must be remembered that no definite preference can be shown for any one method under all circumstances. Depending upon the situation and the over-all long-term implications for the economy, one or the other method may be used. It is obvious that a part (and a major part for that) of government expenditure will have to be financed through tax revenue. The real issue therefore is to decide how to choose between tax and debt finance for that excess of expenditure which is occurring as such.

According to Gurley and Shaw, the mounting volume of public debt is a necessary feature of a strong and healthy financial structure of the economy. With that end in view, therefore, some secular increase in public debt should be planned by every modern government where the economy is market-oriented. However, it appears that no government plans a long-term increase in debt with that end in view. The volume of public debt has tended to increase as a historical evolution and no more. Its benefits through the contribution to the financial structure of the economy are only incidental.

Under some circumstances debt financing becomes either necessary or preferable. Thus under war and other emergencies when suddenlye

large funds are needed and additional tax revenue cannot be raised, debt financing has to be resorted to. Actually most of the public debt in many countries has accumulated on account of war financing. Similarly, another reason necessitating debt financing is where actual tax receipts are falling much below the anticipated volume, while expenditure is not showing a corresponding reduction or is tending to go up.

A third good case for debt financing will be that where the debt is meant for particular projects. Such projects are estimated to benefit certain areas or certain sections of the people who can be expected to bear the cost of the project out of the benefits they would receive. For example, a particular irrigation dam might help the farmers of a particular area. In that case the cost of the dam can be first met through public borrowings, and then it can be recovered from the beneficiaries through a levy or some other means. In the same category, there can be some commercial projects which are helpful for the economy and which can be expected to be self-financing. Their investment funds can be raised through market borrowings and the debt can be retired through the profits of these undertakings. Examples are of electricity generating projects, transport undertakings, and so on.

Debt financing, however, as compared with tax financing has its own limitation which can sometimes outweigh its advantages. Public debt, by definition, has to be serviced. Interest has to be paid on it, and principal is also to be repaid. This means that those who contribute to the financing of the expenditure in the first instance really do not lose. In the case of taxation, the tax-payers straight away lose certain resources in favour of the government without any claim to recovery of these resources. Debt financing, therefore, adds to the future budgetary commitments of the authorities. A part of the future revenue has to go to the servicing of the debt. Ordinarily therefore, the authorities may be expected to favour tax financing, unless the other attending considerations are more weighty. Moreover, since it is the richer sections only which can subscribe to the public debt, debt servicing becomes a medium for redistributing national income in favour of the rich unless counter-balanced by taxation measures. It is also a possibility that the projects chosen for debt financing are really not run efficiently enough and do not generate surpluses to pay off their cost. But this, we must remember, is a question of wrong calculations at the planning stage and mismanagement of the projects which should be avoided. A major drawback of debt financing of a war would be that the effective supplies in th

market would be reduced without a corresponding reduction in the purchasing power. In the case of taxation, this would not be so. Therefore, the problem of keeping inflation under check will be greater under debt financing than under tax financing of a war.

Burden of Debt

A lot of discussion has taken place on this question in economic literature. The classical philosophy of *laissez-faire* equated a sound budgetary policy with that of private budgeting. Just as a private economic unit cannot and should not run into a persistent deficit, similarly, the government should avoid repeated deficits. Any deficit, indebting the government to the market, should be wiped out as soon as possible. "The national debt used to be regarded as the aftermath of war, an incubus to be swept away as quickly as the tax-payer would allow; and the management of the debt used to consist of a search for the cheapest way of dealing with a nuisance."[6] In line with this philosophy, public debt was often divided into productive and dead-weight debt. The general idea was that the government should not raise loans for consumption activities; at the most it may do so for the investment activities only. Public debt should not become a drain upon its budget. Debts raised during a war etc. were, therefore, very obnoxious according to this approach.

The same line of reasoning, that is, interest payment on public debt should be taken to represent a 'burden of debt,' was emphasized and elaborated by E.D. Domar.[7] He related the interest payments to the level of national income and thus pointed out that as interest on debt as a proportion of national income rises, a larger portion of national income will have to be taxed to pay that interest. We must, however, remember that the tax revenue collected for interest payment, is being disbursed to the debt holders. The burden that arises from a large public debt and a large tax collection for interest payment, therefore, really depends upon two things. *Firstly*, it depends upon the wastage that takes place in termls of administrative costs of administering the tax collections and interest payments. *Secondly*, it depends upon the distributive effects that such a process generates. If, for example, through this taxation and interest payment, the income inequalities increase, public debt may be claimed to have added to the burden of the debt. In India, for example, most of the funded public debt and treasury bills are owned by the Reserve Bank of India

[6]Radcliffe Committee, *op. cit.*, para 530.

[7]E.D. Domar, "The 'Burden of the Debt' and the National Income," *American Economic Review*, December 1944.

and other institutions. This, therefore, does not cause any redistributive problem through interest payments. Additionally, the government obligations arising out of provident funds, small savings and so on are generally owned by middle class income groups and this again is expected not to increase the income inequalities. Financing of these interest payments, however, may be forcing the authorities to resort to indirect taxes, which of course tends to increase inequalities.

There have been other views also according to which public debt is burdensome. Some of these views are not completely logical because they distinguish between the private and government sectors of the economy and try to consider the effect upon private sector only—that also, in many cases, without conceding the fact that there are transfers from the government sector to the private sector also. Thus, one such view is that debt financing is burdensome as compared with tax financing because it involves future taxation also to service the debt. We have seen above that the burden involved here may arise out of extra cost to the economy in conducting all these operations and through their redistributive effects but not on account of these transfers as such. These transfers are within the economy from some economic units to the others.

External debt, however, stands on a different footing. At the time of contracting external loans, the debtor country gains in terms of real resources. It either gets consumption goods or capital goods from the lender country. However, at the time of interest and principal repayments, an outflow of resources takes place. In ordinary terms, if the borrowing country had acquired consumption goods, it would not add to the productive capacity of the country and so at the time of repayment of the loans, there will be a net loss of resources. To the extent that the loans carried interest also, the outflow of resources will be larger than was the inflow. It must, however, be remembered that it need not always be so. Since final payment of the debt has to be in terms of excess of exports over imports, the net outflow will also depend upon the changes in terms of trade from the time of contracting the loans to the time of their repayment. If the terms of trade have moved in favour of the debtor country, then to that extent the burden of the debt is reduced. The debtor country may even gain in the net.

Foreign loans, however, may be used for investment purposes in which case the productive capacity of the debtor country will increase out of which the debt repayment can take place. In this case, therefore, there need not be any net burden. Of course, if the

loans have not been invested in export-oriented industries, or if otherwise the exports of the debtor country do not increase, then there will be balance of payments difficulties at the time of repayment. This has happend with many underdeveloped countries. A UN study shows that "during 1969-71, the servicing payments on the official and officially guaranteed debt of 81 countries increased nearly twice as fast as the export earnings out of which the payments are, for the most part, financed."[8]

Debt Burden and Future Generations

It is sometimes claimed that debt financing of current expenditure leads to a burden upon future generations of the society. There are two inter-related questions involved here. The first is whether debt financing *necessarily* imposes a burden or a sacrifice upon the future generations; and the second is, whether it is possible to *make the future generations* contribute to the present utilization of resources through debt financing.

The classical position in this connection is that through debt financing, it is the present generation which suffers a loss of resources. The future generations will suffer if the present generation reduces its savings to meet the debt finance and thereby leaves a smaller amount of capital resources for the future. This will reduce the productive capacity of the coming generations and they will accordingly lose.[9] We must note that in reality, current financing (of say a war) requires resources today itself. The present generation, therefore, either has to reduce its consumption or saving or both. When, however, savings are reduced, the future generations *also* suffer on account of reduced inheritance of capital stock. The present generation, by not reducing its consumption, is passing the burden on to the future generations. It should be noted that here the burden is being conceived in terms of reduced consumption availability (which the present generation is making the next generation share with it). When, therefore, it is suggested that through public debt financing the burden will be passed on to the future generations, while through tax financing it will not be, the suggestion is that in the case of tax financing the present genera-

[8]UN, Report of the UNCTAD Secretariat, *Debt Problems in the Context of Development*, Geneva, 1974, Summary and Conclusions, para 1.

[9]This argument was supported, for example, by Lerner and Samuelson. See, Abba P. Lerner, "The Burden of the National Debt," in *Income, Employment and Public Policy*, New York, Norton, 1948, pp. 255-275; also his, "The Burden of Debt," *Review of Economics and Statistics*, May 1961, pp. 139-41; Paul A. Samuelson, *Economics*, McGraw Hill, 1964, Chapter 18.

tion will correspondingly reduce its consumption while in the case of debt financing it will not. There is a substance in this argument. Debt financing leaves in the hands of the debt owners bonds and securities which they consider as part of their wealth. While in the case of taxation, they would believe themselves to be poorer, in the case of debt financing, they are not likely to think so. Accordingly, under debt financing, consumption is not likely to fall. Thus we find that debt financing can impose a burden upon future generations, but it is not a result that must necessarily follow.

This stand has been challenged by quite a few writers like Buchanan, Bowen, Davis, Kopf, Musgrave. Modigliani and others. James Buchanan, in his book *Public Principles of Public Debt* takes the position that a burden implies a compulsory sacrifice.[10] The present generation of bond holders happens to subscribe to the public debt *voluntarily* and therefore it is not a burden upon them. It is however a burden upon the future generations which will have to pay taxes *compulsorily* for its retirement and interest payments. Buchanan is obviously taking an individualistic view-point where for an individual a tax is a burden while a debt subscription is not. But for the economy as a whole such an approach does not hold good. For the economy, the burden consists in terms of the loss of resources whether it is on a voluntary basis or a compulsory basis.

Earlier it has been pointed out that if the present generation provides the resources for debt financing by cutting its consumption, then savings and capital formation would not be affected and the future generation would not be burdened through inheritance of reduced capital stock. Bowen, Davis and Kopf take the extreme position where the present generations choose *not to* reduce its consumption at all, but finance the entire debt through reduced savings.[11] Modigliani tries to show that debt financing by the government will necessarily lead to reduced capital stock with the future generations.[12] If the economy is already having full employment and the government increases its own expenditure, this will necessarily reduce either private consumption or investment. Now since the government is financing its operations through borrowings, and borrowing mostly come out

[10]James Buchanan, *Public Principles of Public Debt*, Richard D. Irwin, 1958.

[11]William G. Bowen, Richard D. Davis, and Davis H. Kopf, "The Public Debt: A Burden on Future Generations?," *American Economic Review*, September 1961, pp.701-706.

[12]Franco Modigliani, "Long-Run Implications of Alternative Fiscal Policies and the Burden of the National Debt," *Economic Journal*, December 1961, pp. 730-58.

of the savings, therefore, the capital stock of the future generations will be reduced. To a lesser extent, the same effect will hold even when the economy is working at a level below full employment.

All the above analysis and arguments, it would be noted, are ignoring the expenditure side of the government activities; or to put it differently, it is being assumed that the government expenditure will necessarily be of the consumption type such as in the case of a war. In an underdeveloped country, especially, public debt may be raised with the specific intention of increasing investment and capital stock. To a smaller or larger extent the same may be the plans of a developed country also. It will be totally unrealistic, therefore, to assume that all government expenditure is bound to be of consumption type, especially if it happens to be debt financed. It is for this neglect of the expenditure side of the government's budget that Mishan calls all those who support the theory of shift of burden to future generations, the 'burden mongers.'[13] The net effect of any debt operation, therefore, need not be burdensome for the future generations at all.

There is, however, one clear-cut case where the burden of the debt can be passed on to the future generations. It is when the debts are raised externally. The current generation receives the resources (whether for consumption, or investment, or for destruction in a war) and the future generations pay back the debt. The future generations *may not feel* the burden on account of increased productivity etc., but the burden of repayment certainly lies on the future generations.

Debt Redemption

The traditional thinking on this problem has already been noted. It prescribed a policy of paying off the public debt as soon as possible (though in practice some governments defaulted in debt repayment and even repudiated it). Current thinking, however, considers debt retirement in the context of over-all debt and fiscal policies of the government and would favour the repayment of the debt in terms of the circumstances attending upon such repayment.

One simple way of ending the debt obligations is to repudiate the debt. This is, however, totally undesirable from many points of view. It is usually wrong on the part of the government to do so, and it hits the credit of the government with the result that it will find very difficult to borrow in future, and at reasonable rates. From the point of view of the debt holders, it can be a major financial blow especially

[13]E.J. Mishan, "How to Make a Burden of the Public Debt," *Journal of Political Economy*, December 1963, pp. 537-42.

in the case of those creditors who had invested their life-savings in government debt or who were relying upon the interest payments as a regular source of income.

Assuming that the debt is not to be repudiated and assuming that it is to be retired (and not maintained perpetually), there are two systematic approaches that may be adopted for repayment of the debt. The first is the sinking fund approach in which the government regularly saves for the retirement of the debt and uses the funds for this purpose when they have accumulated enough. The second approach is that of regularly retiring a small portion of the debt every year. It is obvious that irrespective of the method of debt retirement, the government budget must have an over-all surplus (unless the deficit is being met by printing more currency). Without such a surplus, one part of the debt may be retired but there will be a simultaneous addition on account of the deficit also. With a deficit budget the debt retirement will be smaller than the new loans contracted.

Sinking fund approach is practised by a number of governments including India. According to this approach, the government sets aside a certain amount out of its budget every year for this fund. The balances in the fund are also invested and the interest accruing on them is also credited to the fund. It is believed that on account of the compounding of the interest, such a fund should be able to absorb a major portion of the retirement cost when the time for debt redemption comes. Since the public debts were usually incurred during wars and other emergencies and could not be paid off quickly, sinking fund technique was considered a sound and practical one. However, of late this practice has degenerated into only a semblance of it. Compared to the total outstanding debt, the amounts credited to the sinking fund are paltry. Sometimes sinking fund only remains an authorized amount but is not actually there. Cases of misuse of the sinking fund are also not unknown. In India also we maintain a semblance of the sinking fund.

The method of paying off a portion of the debt every year may be effected in two ways. Firstly, the loans outstanding may have staggered maturity dates. The public debt in this case will be in the form of *serial bonds*. The advantage of this method is that the repayment obligations are not concentrated in one period. They are sufficiently well-spread and do not cause an undue burden upon the budget. It may not, however, be always possible to serialize the existing bonds without unduly disturbing the government bonds market. Accordingly, the second method adopted is that of earmarking a portion of the budget for debt retirement, purchasing the bonds

in the market and cancelling them. The danger with this method is that it is of a voluntary character. Under short-term pressures, a government may not adhere to the practice steadfastly and there may be periods in which the policy remains in abeyance.

There are some short-term loans which arise out of temporary deficits and which are automatically paid off with the corresponding surpluses. Similarly, some longer-term loans also, for which certain revenues have been earmarked (such as the revenues from particular projects), are not very likely to pose a debt retirement problem. Other long-term loans keep on approaching their maturity dates and the government may not be in a position or may not want to pay off such loans. In that case a usual technique is that of "refunding the debt." This means that the existing debt is converted into a new one of longer maturity. At the time of repayment of the older debt, the government offers to the market the new issue and the holders of the older debt are given the option to subscribe to the new debt by surrendering the older one. Some debt holders, of course, may opt for cash repayments, and there will be others who pay cash for purchasing the new loan. Refunding is considered quite a legitimate alternative to retiring the debt when the government is not in a position to do so either for budgetary or for policy reasons.

Some Issues in Debt Management

The term debt management refers to the debt policy designed to achieve certain objectives and actual implementation of this policy. Thus, according to the traditional philosophy the debt management was to consist of raising the necessary debt at the cheapest interest cost and paying it off as early as possible. However, with the development of the concept of a welfare state, now various objectives are being considered as the cornerstones of a sound debt management policy. Of course, every government is still interested in keeping the interest cost of its debt at the minimum possible but when this objective comes into conflict with other objectives, it may be sacrificed. Other important objectives attracting the attention of the authorities include anti-cyclical or stabilization objective, economic growth and refunding.

Debt management policy has to run in harmony with the monetary management of the country. They both influence stabilization and economic growth. Through general and selective credit controls monetary policy tries to influence the volume and directions of the flow of funds and thereby guide the working of the economy. The way in which debt management can also contribute to this policy objective

has been discussed above. It has also been seen how the objective of reducing the interest cost on debt can come into conflict with the anti-cyclical monetary policy of the country.

Another point to be noted is that the aggregate volume of debt is a result of fiscal action, that is the budgetary policy of the government. The volume of debt will increase or fall in line with the deficit or surplus budgeting. In monetary policy, on the other hand, there is no such limitation. The volume of money and credit in the market may be regulated quite independently to a large extent. In the case of public debt, the management part would mainly consist of changing its maturity composition so as to effect its yield structure and the liquidity content. But it must be emphasized that the monetary policy and public debt are closely linked. In monetary policy, open market operations are normally conducted in the sale and purchase of the government securities.

In a big country, where the government has more than one layer (such as the Central and the state Governments), therecan be problems of coordination between debt operations and indebtedness between these governments. If, for example, both the central and the state governments are allowed to enter the market for raising loans, care would have to be taken that the timings, amounts, terms and other conditions of the loans are not working at cross purposes. Normally, the central governments is able to borrow at lower rates than the state governments. Therefore the rates of interest offered on central and state government should vary to accommodate for this fact. Again different governments should avoid entering the market at the same time or in quick succession if the availability of funds in the market is limited compared with the combined requirements of the governments. In India, the task of coordination in all these respects is achieved through the agency of the Reserve Bank of India. It is the agent of both the Central and State Governments in all debt operations. It also advises them regarding the timing, terms, and the amounts of loans that can be raised in the market without undue difficulty.

11 PUBLIC EXPENDITURE—GENERAL CONSIDERATIONS

MEANING AND NATURE OF PUBLIC EXPENDITURE

Public expenditure refers to the expenses which the government incurs for its own maintenance as also for the society and the economy as a whole. These days, some governments are incurring expenditure to help other countries and that would also form a part of the total public expenditure. With expanding State activities, it is becoming increasingly difficult to judge what portion of the public expenditure can be ascribed to the maintenance of the government itself, and what portion to the benefit of the society and the economy.

Though historically public expenditure is found to be continuously increasing over time in almost every country, traditional thinking and philosophy have not been very encouraging to the growth of public expenditure. It is because the market mechanism was considered a better method whereby the working of the economy could be guided and the allocation of the resources could be decided. It was argued that each economic unit was the best judge of its own economic interests and the government was certainly not able to decide on behalf of others. Furthermore, while a private economic unit was guided by its own economic interests, the public sector would not be having any such motivation. Accordingly, efficiency would be at a low ebb there. Had this philosophy been practised also in its entirety, public expenditure would not have grown as rapidly as it did. In reality, however, the problems of labour exploitation, economic and social injustice and such like things assumed serious proportions and could not be ignored. The result was that along with the advocacy of *laissez-faire*, various socialist and welfare ideas also gained currency. And of course the governments found that they could no longer remain silent spectators of the miseries of the people.

However, in spite of the fact that public expenditure has increased rapidly during the last two centuries or so in almost every State, and in spite of its growing role and importance in national economies, the area of public expenditure remains relatively unexplored. As Lowell Harris says, the economists have generally concentrated their attention no the theory of taxation. The theory of public expenditure has been

more or less confined to that of generalities in terms of the effects of public expenditure on employment and prices etc.[1] Of course, it may be pointed out, that lately this deficiency is being removed by various studies in the field of public expenditure.

There are two important and well-known *theories of increasing public expenditure* which we shall be discussing below. The first one is connected with Wagner's name and the other with Wiseman and Peacock.

Wagner's Law of Increasing State Activities

Adolph Wagner (1835-1917) was a German economist who based his *Law of Increasing State Activities* on historical facts, primarily of Germany.[2] According to Wagner, there are inherent tendencies for the activities of different layers of a government (such as central and state governments) to increase both intensively and extensively. There was a functional relationship between the growth of an economy and the growth of the government activities so that the governmental sector grows faster than the economy. F. S. Nitti supported Wagner's thesis and concluded with empirical evidence that this 'law' was not only applicable to Germany but to various governments which differed widely from each other.[3] All kinds of governments, irrespective of their levels (say, the central or state governments), intentions (peaceful or warlike), and size etc., had indicated the same tendency of increasing public expenditure.

Firstly, the traditional functions of the State were expanding. Defence was becoming more expensive than ever before. Within the country, administrative set up was increasing both in coverage and intensity. The government machinery had to be manned by experts in their fields. Administration of justice etc., was becoming more expensive and cumbersome as the society progressed. An additional force pushing up public expenditure here is the fact that various complexities of social and economic nature develop which make an efficient administration also more complex and expensive.

Secondly, the State activities were increasing in their coverage. Traditionally the State activities were limited to only defence, justice, law and order, maintenance of the State and social overheads. But

[1]C. Lowell Harris, "Public Finance," in B.F. Haley (Ed.), *A Survey of Contemporary Economics*, Homewood III, 1958, II, pp. 261-62.

[2]Adolph Wagner, *Finanzwissenschaft*, 3rd edn., 1890; and also *Grundlegung der Politischen Oekonomie*, 3rd edn., 1893

[3]F.S. Nitti, *Principidi Scienza delle Finanze*, 1903.

with the growing awareness of its responsibilities to the society, the government was expanding its activities in the field of various welfare measures. These included the measures to enrich the cultural life of the society and also those designed to provide social security to the people (such as old age pensions and so on). Subsidies for and direct provision of various merit goods and public goods were on the increase. State activities were also increasing on account of its efforts at redistributing income and wealth.

Thirdly, the need to provide and expand the sphere of public goods was being increasingly recognized. The State was trying to shift the composition of national produce in favour of public goods and this necessitated the expansion of the investment activity of the government.

Wagner's law was based upon historical facts. It did not show the inner compulsions under which a government *had* to increase its activities and public expenditure as time passes. His law was applicable to modern *progressive* governments only in which the State was interested in expanding the public sector of the economy and undertake other activities for the general benefit. This general tendency of expanding State activities had a definite long-term trend, though in the short-run, financial difficulties could come in the way. "But in the long-run the desire for development of a progressive people will always overcome these financial difficulties."[4]

Wagner, thus, was emphasizing the long-term forces, rather than short-term changes in public expenditure. He was also not concerned with the mechanism of increase in public expenditure. Since his study is based on the historical experience, the precise quantitative relationship between the extent to which public expenditure would increase and the time taken was not fixed in any logical or functional manner. The fact that, over time, public expenditure had been increasing could not be used to predict the extent to which public expenditure would change in future. Actually, it is consistent with Wagner's law to state that in future the State expenditure would increase at a rate slower than the national income though in the past it had increased at a faster rate. Thus in the initial stages of economic growth, the State would find that it has to expand its activities quite fast in various fields like education, health, civic amenities, transport, communications, and so on. But when such an initial deficiency is met, then the increase in State activities may be at a rate slower than the over-all growth in the economy.

[4]Adolph Wagner, *Finanzwissenschaft*, Leipzig, 3rd edn., 1890, part I, p. 16.

Additional factors which contribute to this tendency of increasing public expenditure would include the necessarily growing role of the State in the increasing complexities of modern life.

Firstly, we note that population itself is increasing in most cases which thus becomes a major contributing factor to the growth of public expenditure. The sheer scale of various public services has to increase in harmony with the population growth. For example, more schools, hospitals, and such like services have to be provided to meet the extra needs of the growing population.

Secondly, an increasing shift of population to the urban areas takes place. Existing cities grow and new ones come up. Urbanization implies a much larger per capita expenditure on civic amenities. Also quite a good amount of incidental services like those connected with traffic, roads, and so on have to be provided.

Thirdly, it is noticed that prices have a secular tendency to go up. Though there are periods when prices have fallen, the over-all trend has been for them to rise.

Fourthly, the size and nature of public services now involves specialization. The quality of the services improves, both as a historical fact as also due to circumstantial compulsions. Better quality services and higher qualified administrators, technicians etc., imply a higher cost of providing the public services. The government has to purchase a number of goods and services for its own maintenance also. With rising prices, expenditure on them also goes up.

Fifthly, a modern government considers it a part of its duty to protect the economy from the evils of market mechanism. Accordingly, anti-cyclical and other regulatory measures are adopted. Efforts are made to reduce the income and wealth inequalities and bring about social and economic justice. Quite a sizeable expenditure on various welfare and social security measures is undertaken and it tends to increase.

Sixthly, modern governments have shown a tendency to run into debt and this leads to a subsequent increase in public expenditure in the form of increasing cost of debt servicing and repayment of the loans.

Seventhly, the ideals of planning and economic growth are being increasingly accepted and this implies an increase in public sector as also various efforts on the part of the government towards capital accumulation and economic growth.

Wiseman-Peacock Hypothesis

The second thesis of eht growth of public expenditure was put

forth by Wiseman and Peacock in their study of public expenditure in UK for the period 1890-1955.[5] The main thesis of the authors is that public expenditure does not increase in a smooth and continuous manner, but in jerks or steplike fashion. At times some social or other disturbance takes place which at once shows the need for increased public expenditure which the existing public revenue cannot meet. While earlier, due to an insufficient pressure for public expenditure, the revenue constraint was dominating and restraining an expansion in public expenditure, now under changed requirements such a restraint gives way. The public expenditure increases and makes the inadequacy of the present revenue quite clear to every one. The movement from the older level of expenditure and taxation to a new and higher level is the '*displacement effect.*' The inadequacy of the revenue as compared with the 'required' public expenditure creates an '*inspection effect.*' The government and the people review the revenue position and the need to find a solution of the important problems that have come up and agree to the required adjustments to finance the increased expenditure. They attain a new level of '*tax tolerance.*' They are now ready to tolerate a greater burden of taxation and as a result the general level of expenditure and revenue goes up. In this way, the public expenditure and revenue get stabilized at a new level till another disturbance occurs to cause a '*displacement effect.*' Since each major disturbance leads to the government assuming a larger proportion of the total national economic activity, the net result is the '*concentration effect.*' The concentration effect also refers to the apparent tendency for central government economic activity to grow faster than that of the state and local level governments. British data are consistent with this finding, but its application to other countries needs verification. Moreover, this aspect of concentration effect is also closely connected with the political set up of the country.

On the face of it, Wiseman Peacock hypothesis looks quite convincing. But we must remember that they are emphasizing the recurrence of abnormal situations which cause sizeable jumps in public expenditure and revenue. In all fairness to the historical facts, we must not forget that on account of the advance of the economy and the structural changes therein, there are constant and regular increments in public expenditure and revenue. Public expenditure has a tendency to grow on account of a systematic expansion of the public activities as also an increase in their intensity and quality. Increasing population,

[5]Jack Wiseman and Allan T. Peacock, *The Growth of Public Expenditure in the United Kingdom*, Princeton University Press, 1961.

urbanization and an ever-increasing awareness of the civic rights on the part of the public, coupled with an increasing awareness of its duties on the part of the State, leads to an upward movement of public expenditure. To an extent this public expenditure gets financed by ever-increasing revenue also which is made possible through the expansion and structural changes in the economy. These days, in underdeveloped countries like India, the State is deliberately trying to increase its activities and makes an effort to finance those activities through various tax efforts. Even in developed countries, the State finds that it has an increasing regulatory duty towards the economy to protect it against instability and excessive inequalities of income and wealth. Thus, Wiseman-Peacock hypothesis is still a description of a particular tendency and does not isolate all the relevant causes at work.

It must be emphasized that apart from various factors like population growth, defence expenditure, urbanization, rising prices etc., which by themselves were pushing the public expenditure up, an important force in the field has been the failure of the market mechanism to let the economy achieve its various objectives efficiently. Inherent deficiencies of market mechanism make the economy a prey of economic instability, income and wealth inequalities, defective patterns of consumption, employment and investment and so on. In a number of cases the market mechanism is not able to pull the economy out of its vicious circle of poverty and launch it on a path of secular and rapid economic growth. Perforce, then, the sphere of government activities increases and has led to a corresponding increase in public expenditure also.

The Critical-Limit Hypothesis

Colin Clark in his "Public Finance and Changes in the Value of Money" (Economic Journal, December 1945, pp. 371-89) puts forth what he calls the 'critical-limit' hypothesis regarding tax tolerance. Colin Clark based this hypothesis on the inter-War data of several Western countries. The hypothesis is that when the share of the government sector exceeds 25 per cent of the total economic activity of the country, inflation occurs even under balanced budget. To support his contention, Clark argues that when the government share of the aggregate economic activity reaches the critical limit of 25 per cent, the income earners are so affected by reduced incentives (due to high tax incidence) that their productivity suffers. They produce much less than what they are capable of, leading to a curtailed supply. On the other hand, demand-effects of the government financing become

quite strong even if the budget remains balanced. All told, inflation results from this maladjustment between demand and supply. The basic defect of Clark's hypothesis is its reliance on the institutional framework of the economy, and the choice of a definite figure (25%) as the critical limit. It would have been more acceptable to assert that in a market economy, increasing state activity leads to mounting inflationary pressures. As it is, quite a few countries have crossed the 25% limit without confronting significant inflationary pressures. Moreover, whether or not government's budgetary activities would lead to inflation also depends upon the manner in which public expenditure is incurred.

Comparison between Private and Public Expenditure

With regard to similarities between the public and private expenditures, we must remember that neither the private units nor the public authorities would like just to waste the expenditure without any corresponding 'return.' Given the objectives to be achieved, each will try to achieve it with the minimum possible expenditure. Any shortfall on this front will be on account of inefficiency, uncertainty, lack of foresight and similar other causes. Another point of similarity between the two is that in both the private and public expenditures there is an element of flexibility, though it is generally more in the case of public expenditure. Both private economic units and public authorities take a collective view of the income, expenditure and the possibilities of adjustments in each. While an individual will consider the possibilities of shifting his total time between an effort to earn and leisure, and a firm will think of the cost of earning more and spending more, the public authorities will compare the effects of additional revenue raising efforts with the results of extra expenditure. It must also be remembered that in each case there can be more than one way of raising additional income. The authorities, for example, can plan to raise the additional tax or non-tax revenue, or borrowing or even raising taxation in various forms. There are, therefore, problems of over-all efficient and integrated management of finances. They are related to the alternative ways in which finances can be raised, the efforts needed to raise them, the effects of such revenue efforts and the corresponding benefits of the expenditures which are to be incurred. It is also obvious that depending upon different circumstances prevailing at the time, the net equilibrating solution will differ. While in some cases a larger tax and expenditure level might be indicated, in others the amount indicated will be smaller. Similarly, in the case of private finance, we have different levels at

which the solutions will be found.

However, while private and public expenditures are similar in their over-all and complex ramifications, the dissimilarities between them are also quite glaring. The first such dissimilarity is the objective with which the expenditure is increased. In the case of an individual economic unit, generally it will be an exchange relationship which will determine the mode, pattern and volume of expenditure. As a consumer, an individual will be equating the marginal utility of the good (or service) purchased against the disutility of expenditure. A commercial economic unit will be comparing the private marginal returns from an expenditure with the amount spent. Public authorities however cannot and do not always adopt commercial attitude towards their expenditure plans. They have to look towards the social benefits which will be generated in the process of their expenditure activities. And in quite a few cases these social benefits are vague and immeasurable. The State has to impute social valuation to these benefits and decide whether it is worthwhile undertaking these expenditures or not. Also, there are certain State expenditures which are in the nature of bringing about social and economic justice in the field of income and wealth distribution. The benefits of such State expenditures again cannot be evaluated directly.

Keeping in view the fact that the State is the guardian of the social welfare and the economic and social health of the society, quite a few items of expenditure are not related to the cost of providing the necessary services. These services can be in the nature of social security and some of them are meant to be of long-term benefit to the society. An individual has a limited horizon and will plan the future only within a foreseeable future. The State will take a very long view. It is with this end in view that the State may even plan to incur public expenditure in such a way that it runs into a kind of permanent deficit. A private economic unit cannot do so. These days, most States are finding the philosophy of functional finance a better approach than the traditional approach of *prudish budgeting* according to which deficits or surpluses could only be temporary. The objectives of public expenditure are now far wider than imagined earlier.

PURE THEORY OF PUBLIC EXPENDITURE

Public expenditure theory, traditionally, received only a scanty attention till recently. Partly, this lop-sided interest in the theory of public finance is explained by a general acceptance of the philosophy of *laissez-faire* and a belief in the efficacy of free market mechanism.

Under this reasoning, the State had a limited and set necessary functions to perform for which it needed to raise the requisite revenues. The problems, therefore, was mainly the determination of the 'best' way in which the required revenue could be raised. However, with the advent of welfare economics in which the role of the State is explicitly recognized and in which budgetary operations assume a significant role, theory of public expenditure started attracting increasing attention. This tendency has been further reinforced by the widening interest of economists in the problems of economic growth, planning, regional disparities, distributive justice and the like.

The theory of public expenditure may be discussed in the context of the 'range' of public expenditure and/or in terms of the division of a given amount of public expenditure into different items. The former of the two parts may also be conceived in terms of allocation of the economy's resources between providing public goods on the one hand and private goods on the other. Partly, we have had the occasion to discuss it in terms of the principle of maximum social advantage (through which the optimum size of the budget is sought to be determined) and partly through a discussion of Lindahl's solution. It would be recalled that Lindahl's solution was attempted along with the objective of providing the State services at full cost to the members of the society and apportioning the cost of service between different beneficiaries on the basis of their respective preference-scales. The second question facing the theory .of public expenditure has widened the field of discussion and analysis and now we have many diverse areas to which the theory of public expenditure has extended itself. The theory, for example, has tried to address itself to the question of what public expenditure wants to achieve for the members of the society. In technical terms it would mean specifying the *objective function* of a public expenditure project. This would obviously involve steps of identifying the restricting conditions (or *constraints*) upon the achievement of this objective function, the use of cost-benefit analysis, the use of important determining variables like the interest rates, and the treatment of risk and uncertainty associated with any project. Such a wide coverage obviously admits of mathematical models which may be quite simple or sufficiently complex with the help of which various rules of public expenditure are derived. Such models have been developed by Frisch, Tinbergen and Theil etc. at macro-level while there are other models dealing with decision-making problems at local and other micro-levels. The abstract theory of public goods and public expenditure started with the recognition of the fact that in public expenditure areas the con-

ventional theory of value breaks down and starting with Wicksell, Lindahl and others, the mathematical model building and abstract treatment of the theory have become quite advanced at the hands of Samuelson, Musgrave and the younger economists.

As noted above, the starting point of the theory of public expenditure is the failure of the market mechanism to respond fully to the true needs of the society. Or to put it differently, market mechanism is not able to bridge the gap between private and social costs on the one hand and private and social benefits on the other. In this section we shall briefly mention the difficulties which the theory of public expenditure faces when addressing itself to the typical questions. It may however be added that greater the imperfections of the market mechanism with reference to the chosen objectives of the society, greater would be the need for the authorities to expand their activities.

It is obvious that the public expenditure theory can be satisfactory only when it is able to provide a simultaneous determination of the tax payments also. Samuelson has shown that it is difficult to devise a mechanism which could generate proper signals regarding the true preferences of the society. Moreover, even if we are able to devise a fulproof signalling system to ascertain the preferences of the society, the same may be inconclusive or contradictory. Arrow provides a classic illustration of such an inconclusive result. Supposing there are three individuals and there are three alternatives A, B, and C to be arranged in descending order of preference. Assume that the three individuals have the following voting pattern:

Individual 1: A preferred to B, and B preferred to C

Individual 2: B preferred to C; and C preferred to A

Individual 3: C preferred to A; and A preferred to B

We find that A is preferred to B by a majority vote, and B is preferred to C by a majority vote from which it follows that A is preferred to C by a majority vote. But the voting pattern also shows that C is preferred to A by a majority vote. The signal regarding the community's preference is therefore inconclusive.

Similarly, suppose that people choose *not* to have any public goods at all. Should it mean that the State should cease to exist? Actually we know that there is a critical minimum of public services which any State must provide such as defence, law and justice. Also there are many contractual payments and other traditional expenses which the State is under obligation to incur such as debt servicing, payment of pensions, salaries etc. Moreover, with the passage of time, there is an inherent tendency for public expenditure to increase. It is in this context that we have the theories of Wagner and Wiseman and

Peacock (discussed above in this chapter).

The range of State activities is widening and is no longer confined to any pure public good (actually it is difficult to come across many pure public goods; most of them will have only a dominant publicness in them). Moreover, as is now recognised, the State activities are increasingly covering distributional, welfare, planning, growth and other areas. They are also keen on expanding the supply of merit goods and forcing their consumption upon the members of the society. A whole set of questions relating to public utilities and other public enterprises has cropped up. Same is the case with public debt—an instrument through which public expenditure can be financed and which can also be used as a policy tool in many fields. In a way, therefore, it is very difficult to handle the theory of public expenditure in its pure form, when it comes to the practical aspects of the problem.

Kinds of Public Expenditure

It is conventional to classify public expenditure into various economic categories. *Accounting classification* has been there for centuries because it is through this classification that the State executive maintains an effective control and check over public expenditure and possible leakages and wastages, diversions and misappropriations. It may be departmental classification or classification according to heads of expenditure.[6] Such a classification is good for auditing and for safeguarding against misappropriations, etc., but it does not help us in understanding its effects. It is, therefore, difficult to formulate an appropriate expenditure policy on this basis. In the same way, a distinction between obligatory (or legally committed) expenditure and optional expenditure can only highlight the constraints under which the government's budgetary policy has to work. It cannot bring out fully the possible effects to different expenditure policies.[7] These days, however, an increasing need for a useful and effective classification of public expenditure is felt. It is only through such classification that the economic effects of various State activities can be gauged and proper policies formulated. A fuller discussion of the economic classification of the government budgets will be taken up in a later portion of the book. Here, however, we can take up two classifications of public expenditure, each of them indicating an area of possible effects on the economy.

[6] Hugh Dalton, *Principles of Public Finance*, 1954, p 144,
[7] See A C. Pigou, *A Study in Public Finance*, 3rd edn , Ch. V.

Productive and Unproductive Expenditures. The first one is the distinction between *productive and unproductive* expenditure. The accepted approach here is to emphasize that while some expenditures were in the nature of consumption, others were in the nature of investment and helped the economy in improving its productive capacity. Under the *laissez-faire* philosophy, the only productive public expenditures would be those which were incurred to create and maintain social overheads. Expenditures on administration, defence, justice, law and order, and maintenance of the State were unproductive. Adam Smith believed that an economy added to its productive capacity in the long run only through additions to its capital stock and production of tangible goods. If we extend this logic to public expenditure, it will follow that only those public expenditures were productive which created some tangible assets in the economy such that those tangible assets, in their turn, enabled the economy to produce more in future. Some people would like to adhere to the usual classical thinking in which the government sector is considered as something foreign and alien to the economy proper. In that case, only those public expenditures would be productive which added to the tangible assets of the government, or more precisely income-yielding tangible assets of the government. Public expenditure may be on various public enterprises of commercial type. The government could be changing for the services of these enterprises to pay for them. They could even be a source of profit to the authorities. Depending upon the pricing policies and other factors, such public expenditures may be self-liquidating partially or fully; that is to say the government might be recovering the public expenditures from the beneficiaries of these projects.

It is obvious that such views are deficient in their analytical and realistic contents. Basically the government sector is a part and parcel of the economy as a whole and must be considered as such. Accordingly, whether an asset is added to the ownership of the government or to that of the private sector should not be the determining factor in deciding about the productiveness or otherwise of any public expenditure.

Secondly, it would also follow that there would be many assets which would not be income-yielding to the government, but which would be really necessary for the productive efficiency of the economy. Such assets ought to be termed productive even though on normal commercial considerations they are not. Parks, water-works and similar goods and services which add to the productive efficiency of the economy must be viewed as productive assets and expenditure

on their creation and maintenance as the productive expenditure. Such public expenditure is, therefore, also self-liquidating in an indirect manner. There will be an increase in the national product and the authorities will be able to collect, even without raising the tax rates or their coverage, an additional revenue.

Thirdly, it is not necessary that the so-called productive assets must be in some tangible form only such as buildings, machinery and the like. The productive power of the society can reside in the form of human wealth also. It can manifest itself in different forms. If through education, training, health, better living conditions, better labour relations, etc., the working population of the country can add to its productive power, the expenditure on such items should certainly be termed productive. Even if some of these expenditures do not add to the productive effort and national income, they will be adding to the enjoyment of the people. Of course, just as some tangible assets can be useless, so can be some expenditures on particular types of education and training, etc. But that is a question of choosing proper forms of education and training which would be useful for the economy.

Fourthly, there are certain public expenditures without which the economy cannot live and cannot maintain its productivity. Rather in many cases such expenditures indirectly help the economy in attaining higher levels of productivity. Examples are those of defence expenditure, expenditure on research, and so on. Even efficient administration, postal and telegraph services, etc., will be indirectly adding to the health and efficiency of the economy. Therefore, a precise distinction between productive and unproductive public expenditures is not easy. Each case has to be judged on its own merits. Basically, we may take the position that any wasteful and avoidable expenditure is unproductive, while all the necessary and relevant expenditure is productive.

Transfer and Non-Transfer Expenditures. This classification was favoured by Pigou. An expenditure may be in the form of a payment which is without corresponding transfer of real resources or their use by the State. For example, the State would be paying interest on its debt, or would be paying old-age pensions, or unemployment benefits, etc. In these cases, the government is simply transferring the right or claim to use the goods and services to certain sections of the society. With the acceptance of the philosophy of a welfare State, even some transfer expenditure may become a non-transfer one. Non-transfer expenditure is that by which the State pays for its purchases or use of goods and services. While in the case of transfer expenditure,

the beneficiaries are to decide about the use of real resources, in the case of non-transfer expenditure, it is the State which uses the resources straightaway. Such a use of resources by the State, of course, may be for consumption purposes or for investment purposes. Expenditure on defence, education and such like things are all of non-transfer or 'real expenditure'[8] type as are the investment expenditures. It must, of course, be remembered that when the government incurs a real expenditure, it is not implied that the government will necessarily purchase at the market rates. For one reason or the other, the government may be purchasing at concessional rates or at non-economic rates.

Canons of Expenditure

Like canons of taxation, people have propounded canons of public expenditure also which should govern the public expenditure decisions. Some of these canons are in the nature of administrative safeguards while others are expected to be of help to the economy and society in their diverse objectives. It, of course, goes without saying that these canons are only broad generalizations and detailed guidelines have to be worked out in each specific case.

(1) *Canon of Economy.* The resources of the economy are always scarce compared with its needs. No wastage should, therefore, be permitted. Public expenditure is the financial counterpart of the resources which the government uses up directly or places at the disposal of certain sections of the society for this purpose. It is therefore, essential that the process of public expenditure should not involve the use of resources more than what are just necessary. Utmost care must be taken to avoid wasteful usage of public funds. And as the sphere of government activities increases both in coverage and quality, it becomes all the more difficult to judge the exact type and extent of wasteful expenditure, Therefore, still greater care and a scientific approach towards the assessment of the required expenditure is needed.

One form of wastage of public expenditure is the delay that often accompanies in formulating the plans of public expenditure, their sanction and their execution. On account of the faulty planning and execution and the delays involved, some benefits are lost; or to put it differently, for given benefits the authorities pay more. Furthermore, on account of delays, when prices are rising, costs themselves go up. These days, various costing methods have been evolved for use of

[8]Dalton, *op. cit.*, p. 145,

continuous check on various cost elements of projects, especially the manufacturing ones. The authorities also use these methods in a number of such projects. In quite a few projects, the cost-benefit approach is adopted in which the social cost and social benefits of a project are estimated (including an imputed valuation of the intangible social costs and benefits) and then the worthwhileness of the project is decided. It must, however. be noted that the techniques of costing and cost-benefit analysis are not applied to all the items of public, expenditure. And there are certain expenditures which are contractual. The authorities are under obligation to incur them (such as interest on public loans) and the question of economy in their use just does not arise.

(2) *Canon of Sanction.* This canon asserts that no public funds should be used without proper authorization and further that funds must be used only for the purpose for which they have been sanctioned. In a democratic set-up, it is the legislature which sanctions the expenditure on demand by the executive authorities. The idea is that such a restriction would avoid unscrupulous and unwanted expenditure and will also be a check against misappropriation of funds. Given the authority by the legislature, detailed authorizations are worked out and at each stage the spending unit has to have the sanction and approval of the appropriate authorities. Since, however, there can always be emergencies and delays in getting the sanction of the legislature for additional funds, a certain flexibility is granted in a number of cases up to a margin.

(3) *Canon of Benefit.* This is clearly related to the canon of economy. Actually economy of expenditure is a relative term and not an absolute one. Any expenditure is to be viewed against the benefits that will accrue from it. Canon of benefit also says that the public expenditure should be incurred only if it is beneficial to the society.

Now the beneficial nature of public expenditure can manifest itself also in the form of various effects on income and wealth distribution, effects on production, and so on. In the final analysis this canon leads the authorities to observe the 'principle of maximum social advantage' which we have already discussed in an earlier part of the book. The additional consideration here would be that it may be possible to re-allocate the same public expenditure between different items in a manner which increases social benefit. The authorities should, therefore, try to choose that combination of items for public expenditure which collectively maximize the social benefit.

(4) *Canon of Surplus.* This canon should actually be interpreted to mean that the government should avoid deficit budgeting, at least a

persistent one. It should always try to be prudent and should aim at meeting its current expenditure needs out of its current revenue. It should not over-spend and run into a debt. Since it may not be possible to avoid some deficits, it would be better if the general effort is directed at achieving a moderate surplus. Such moderate surpluses during some years will take care of reasonable but unavoidable deficits during other years. If on account of war, etc., a large deficit has to be incurred, then the government should try to pay off its debts as soon as possible.

This canon, however, no longer finds favour with the fiscal authorities or with economists in general. This canon was an off-shoot of the *laissez-faire* philosophy. These days, however, the regulatory role of the government is recognized in an increasing measure and therefore the choice of a surplus or a deficit budget is left to be decided on the merits of the case. Thus during depression in a developed country, the government would do well to run into a deficit to stimulate demand and production. Objectives of stabilization and economic growth may necessitate recurring deficits. Resource mobilisation efforts in an underdeveloped country often necessitate a deficit financing. It is a concealed taxation through which the government appropriates additional resources of the economy which can be used for capital formation. In the growth process, the barter sector of an underdeveloped economy gets increasingly monetised while the economy itself grows in complexities. In order to help and sustain this process, the financial and credit structure of the economy must also develop along healthy and efficient lines. To this end, deficit financing, through resultant increase in money supply and public debt, provides the necessary credit base.

12 EFFECTS OF PUBLIC EXPENDITURE

Ideas regarding the need and the effects of public expenditure have varied over time. The earlier approach was closely linked with the philosophy of *laissez-faire* according to which the best government was the one which governed the least. It was argued that every one was the best judge of his own interests and that the government could not be expected to take any decision which was basically superior to the private ones The only sphere where the government could legitimately operate was the preservation of the society and undertaking those activities which were needed by the economy but were commercially unprofitable. It was this logic which delimited the State's legitimate sphere of activities to defence, law and order, justice, administration and social overheads.

However, the fact that the market mechanism failed in many respects to bring about the desired results in the economy, forced an increasing intervention on the part of the State. This not only led to a rapid growth in the government sector and public expenditure but also fed various analytical hypotheses concerning public expenditure. However, we find that on account of the basic differences in the approaches adopted by various writers, we have no general agreement as to the way in which public expenditure can be used and the way it would affect the working of an economy. Thus, we find that some authors have characterized public expenditure as a potent tool for bringing about income and employment stability in the economy. Others are sceptical about the very possibility of using public expenditure usefully. To them public expenditure is a sheer waste and therefore a burden upon the economy. Still others would look at public expenditure as a major weapon for bringing about an egalitarian society--through various welfare measures and so on.

Let us, however, proceed with the recognition of the fact that the government sector is a part of the economy and that it should be treated as such. It is a different thing, of course, that just as different sectors of the economy are interdependent and have influence on each other, similarly, the government sector also is interlinked with the rest of the economy. But there is one major difference. It is that the private sector of the economy is guided by the market mechanism

while the government sector can be used by the authorities to bring about certain changes in the economy. Within limits, the government sector can flout the laws of the market. It is also an important means of directing the working of the rest of the economy. It is this intricate relationship between the government sector and the rest of the economy which spells out different possible effects of public expenditure.

Public Expenditure and Economic Stabilizations

It is a well-known fact that the market forces by themselves leave much to be desired in the field of economic results. The more advanced and free the market mechanism, the more prone the economy is to fluctuations in income, employment, and prices. It is for this reason that with the development of capitalism, free enterprise economies came to experience ever-stronger trade cycles. Accordingly, the need to use some effective anti-cyclical measures was recognized—more so since the havoc which the Great Depression of the 1930's caused. Keynesian diagnosis of the basic cause of the ills of a developed market economy was the deficiency of effective demand which was caused on account of a low marginal propensity to consume coupled with a low marginal efficiency of investment. He therefore advocated a continuous injection of additional purchasing power in the market through stimulation of investment and consumption activities and through direct public investment. This direct investment was a part of the public expenditure. Such a public expenditure was meant to directly add to the effective demand in the market and generate a high-value multiplier by distributing income to those sections of the population which had a high marginal propensity to consume. The addition to demand by such sections would also stimulate investment activity and thus through an all-round increased demand, the depression could be overcome. Keynesian prescription was basically directed towards curing a state of depression - but the logic of the argument can also be extended to that of curing an inflationary situation. To put it differently, Keynesian policy prescription can be developed into a scheme of compensatory finance -correcting the deficiency or excess of demand by the private sector of the economy. During a depression the State was expected to increase total spending in the economy. And this could be done, if need be, through deficit financing. Public borrowings, to the extent they came out of savings of the people, would help in the stimulation of over-all demand when they were spent. This would be more so, when the savings of the people were not finding an investment outlet, due to an all-round deficiency of demand.

Similarly, if deficit financing was being met through creation of additional money, the stimulating effect of additional public expenditure would again be felt. In either case there would be a net increase in total expenditure and demand flows in the economy. During a boom, on the other hand, the need is to curb extra demand. This may be done through reducing public expenditure while maintaining the same amount of taxation and/or borrowings. Here taxation would drain away some of the purchasing power from the hands of the people and public borrowings would be in the same way cut into market investment (since market savings are not likely to go uninvested on account of good investment opportunities). Thus a curtailing of public expenditure would restrain the inflationary pressures.

It must be remembered that the use of public expenditure as an anticyclical weapon implies the existence of a well-knit and sensitive market mechanism where, through the free working of the input-output relationships between different industries, any change starting in one industry spreads to the rest of the economy. It is necessary that such spreading out of effects should be even enough and without undue time lags. And if a depression is to be cured through stepping up of demand, then there must be adequate unutilized excess capacity in the economy. If these assumptions are satisfied, then the authorities have to concern themselves only with the aggregate demand and not with the particular directions in which it is flowing, since through the interaction between demand flows and supply flows, an automatic adjustment takes place In a market where there are technical and other rigidities, the effect created in one sector may not evenly spread to the others. It must be noted that such rigidities are not absent even in developed countries As a result, under such circumstances, public expenditure no longer remains a simple and easy tool.

The authorities have to regulate not only the total magnitude of demand in the economy, they have also to ensure that the subdivisions of the demand flows match the supply flows. Public expenditure as anti-cyclical tool will have to be devised in a detailed manner. If this care is not taken, and if the authorities use public expenditure just to stimulate demand in general, then such a stimulating effect will be felt only for certain items while many other industries and areas would remain unaffected, or would be affected only partially. Actually, it is quite possible that while some sectors of the economy are suffering from lack of demand some others might be groaning under inflationary pressures on account of too much demand. Similarly, it is also possible that when the government reduces its expenditure to curtail over-all demand, the effect is more or less concentrated in the in-

dustries for which the government reduces the expenditure directly.

As is well-known, an underdeveloped country suffers from far greater rigidities than do the developed countries. Shortages of particular materials, machineries, skilled labour, and means of transportation and communication are common. There are gaps in the form of absence of certain industries or adequate productive capacity therein. Various kinds of institutional and legal restrictions prevent a proper and quick market response on the part of different sectors of the economy; and it may be the case even with those sectors to which public expenditure is applied directly. As a result the problem of bringing about economic stability is far more complex in this case.

Another factor which contributes to the complexity of the problem is the fact that an underdeveloped economy is having generally speaking, inelastic demand for essential maintenance imports while demand for its exports is quite weak. The result is that if the world prices for its export fall, this country is forced to distress sales; while if its import prices increase, its cost-price level will be pushed up. Ordinarily an underdeveloped country does not have much defence against this type of instability. Public expenditure cannot remedy the situation to a sufficient degree. Normally, through export and import duties, it should be possible to bring about desired changes in exports and imports, but under unfavourable conditions, this is generally not effective enough. And for some countries, recurring balance of payments problems add to their difficulties.

In summary, we may say that in underdeveloped countries, public expenditure as a general weapon against economic instability has only a limited use; a very detailed programme has to be worked out to meet the specific problems on hand and even then public expenditure alone may not be adequate to overcome the difficulties. A careful and judicious combination of the import and export subsidies, duties and other steps has to be used for achieving effective results.

Public Expenditure and Production

Public expenditure can help the economy in numerous ways in attaining higher levels of production and growth. The various ways in which such effects might be brought about are obviously inter-related. The analysis of these effects can be taken up separately in the context of developed and underdeveloped economies.

Let us first take up the case of a developed market economy. Such an economy has enough of flexibility but may be suffering from a deficiency of effective demand. Public expenditure can add to the effective demand directly and thus generate conditions favourable for

the market forces to push up production. Actually such public investment need not be productive in the sense of adding to the supply side of the market also. This public investment can just be a means of disbursing purchasing power to those who would spend the same and add to the effective demand.

But the technique of increasing production through increasing demand becomes ineffective once the level of full employment is reached. Money income goes up but real income does not increase correspondingly because real income depends upon the use of real resources. If, therefore, demand is pushed beyond full employment, it will only add to the inflationary pressures. It may be noted further that the public expenditure may not be able to push up production proportionately because of various rigidities from which even a developed economy is likely to suffer. For example, some industries may not have unutilized excess capacity when demand goes up. In some industries monopolistic practices may be in vogue and there can be strong militant trade unions. Under different technical and other types of rigidities the economy may not be able to respond fully to increase demand. The result is likely to be a partial increase in production when demand increases through the use of public expenditure and the results can be quite inflationary beyond a limit. Once we recognize the rigidities from which a developed economy may be suffering and the corresponding lack of complete interflow of demand between its various sectors, the coexistence of inflation and unemployment cannot be ruled out. In such a case the authorities cannot be indifferent as regards the manner in which public expenditure generates additional demand in the economy. Specific details of public expenditure would have to be decided so as to achieve selective additions to demand along those lines which suffer from shortage of effective demand.

The case is a different one with underdeveloped economies. Such economies are characterised by a low level of saving and investment activity. This deficiency, again, may be remedied by stimulating private saving and investment, or through direct public saving and investment, or both. Thus in underdeveloped countries, there is a shortage of social overheads, skilled labour, capital equipment and machinery. A number of important and basic industries either do not exist or need to be expanded. Public expenditure can be directly used to create and maintain social overheads. It can also be used to create human skills through education and training. In India, we find a good deal of regional disparities. Certain districts, or parts thereof, have been enlisted as economically backward. Various tax concessions and

credit facilities are being provided for setting up industries in these areas. Public expenditure can be used to provide the necessary economic infra-structure for the development of selected economic activities and can be used to give subsidies for increasing their profitability. Thus the authorities can add to the process of capital accumulation. To the extent that this capital formation is financed through foreign aid, the process of economic growth is accelerated.

In this process of accelerating capital accumulation, the authorities have to take a few precautions so as to maximize the benefits of public expenditure and to avoid the possible harmful incidental effects.

Firstly, these various projects have generally a long gestation period. That is to say, it will take a long time before these projects can start yielding output. Similarly, some other forms of public expenditure (such as on education) will have only long-term beneficial effects on production. But there will be an addition to money income right from the beginning. In the short-run therefore, they will tend to add to the inflationary pressures. Hence, care must be taken that inflationary pressures do not get out of hand during the process of development.

Secondly, on account of faulty planning and execution a lot of wastage can take place in public expenditure. This must be avoided.

Thirdly, because resources are limited compared with their need, care must be taken to choose the most appropriate and most useful projects. A proper cost-benefit study has to be taken for each project as also its relation with other industries in terms of input-output coefficients. Emphasis must be laid on industries to which for various economic and social reasons a high priority is accorded and which satisfy the cost-benefit criteria.

Fourthly, a careful decision has to be taken regarding the volume of public expenditure in various projects and on various measures expected to stimulate private investment. An underdeveloped economy has some untapped resources, but the extent to which they can be utilized in the near future and the extent to which they can be shifted from one use to the other may be limited. Accordingly, the extent and composition of public expenditure are closely linked with the way this expenditure is financed. Financing the public expenditure through resorting to printing press or borrowing from the central bank of the country will add to the aggregate demand in the country. Such a course, therefore, has to be reviewed constantly for its possible inflationary effects. Financing of public expenditure through market borrowings or taxation will drain the private sector of the

corresponding investible resources. Therefore, the net effect will depend upon the uses to which these funds were being put up by the private sector and the uses to which they are put through public expenditure. A detailed analysis of the flow of funds and the changes therein on account of all these public policies must be made on a continuing basis in order to achieve the best possible results.

Public expenditure may also be used to encourage the market sector of an underdeveloped economy for contributing to the process of economic growth. It is not necessary that all the additional investment should be in the form of direct public investment only. Public expenditure can help private investment and production through measures which reduce the cost of production, or push up demand or remove particular shortages and bottlenecks. Creation and maintenance of social overheads would lead to an all-round reduction in cost of production and improvement in efficiency. This, therefore, increases profitability and production. Also social overheads bring different regions and sectors of an economy in closer contact and thereby stimulate the process of economy growth. Also public investment can go directly into the development of basic and key industries, power, irrigation and mines etc. Through these steps the economy can add to its infrastructure and thus provide a firm basis for growth.

Public expenditure can be used to create demand for various products, and thus stimulate private production. A policy of purchasing indigenous goods, like typewriters, fans, etc., will help domestic industries to grow. And if such a demand is directed towards the products of small scale and cottage industries, then there will be a relief on the employment front also. These industries, being labour-intensive, will help the economy in reducing unemployment.

Public sector investment can be specifically directed towards creation of particular supplies and facilities, which form important and necessary inputs for other industries. Imports of essential raw materials can be arranged and special labour skills can be developed. To put it differently, public expenditure can be utilized as a means to remove numerous shortages and bottlenecks in the way of production. Public expenditure can be effectively used in reducing regional disparities also. Industries, especially of particular type, can be subsidized and otherwise helped through loans, etc., if they are established in particular regions. In the same way, a larger production of public expenditure on social overheads can be devoted to these areas. Educational and training facilities can also be provided as a further aid in reducing the regional disparities.

Research and development are important and helpful activities which must be undertaken in a full measure. New, effective and cheap methods of production can be found whereby local resources are used and a saving in imports and foreign change is effected. New products can be invented which will help the economy in its various productive activities. In these diverse ways, the economy can be helped in effecting a re al'ocation of its resources and in the process of economic growth.

Public Expenditure and Economic Growth

The factors discussed above would enable us to see the role of public expenditure in economic growth also. In a developed country, through economic stabilization, timulation of investment activity and so on, public expenditure maintains a rate of growth which is a smooth one. In an underdeveloped country, public expenditure has an active role to play in reducing regional disparities, developing social overheads, creation of infrastructure of economic growth in the form of transport and communication facilities, education and training, growth of capital goods industries, basic and key industries, research and development and so on. Public expenditure has a great role to play in the form of stimulating saving and capital accumulation.

One way in which public expenditure is expected to affect the pace of economic growth is the will and capacity of the people to work, save and invest. In this connection, the exact effect will depend a lot upon the precise form and magnitude of public expenditure as seen in the context of accompanying circumstances. Now when public expenditure is incurred, by itself it may be directed to particular investments or may be able to bring about a re-allocation of the investible resources in the private sector of the economy. This effect, therefore, will be basically in the nature of re-allocation of resources from less to more desirable lines of investment. But whether or not there will be an addition to the total investment activity depends upon a number of additional factors. It will partly depend upon the will of the people to work. There are conflicting views as to whether public expenditure increases the will to work or dampens it. Some welfare expenditures might lead to an effect in either direction. Similarly, the net effect will also depend upon economic activity and investment. An important way in which public-expenditure can accelerate the pace of economic growth is by narrowing down the difference between social and private marginal productivity of certain investments. Here public-expenditure can be used to provide subsidies

for those investments which are commercially non-viable but which are very helpful for economic growth. Such a system of subsidies, for example, may be for agricultural inputs if agricultural production is to be stimulated, or for investment in backward areas to reduce regional disparities and unemployment. Subsidies can also be used to promote import substitution and, at the same time, to keep the prices of necessary imports of capital goods etc., low. As far as savings are concerned, it may be presumed that public expenditure would be designed in such a way as to increase the over-all savings in the country, though of course not necessarily so. Some public expenditure may be in the form of education, various social services and so on in which case it will lead to an increase in consumption rather than savings. On the other hand, to the extent public expenditure helps the people in attaining higher efficiency and productivity, their capacity to work and save will increase. But above all, we must recognize the lead which public expenditure, if used in a judicious way and with a purpose, can give to the economy. It has a capacity to open up vast opportunities and it can create an awakening and desire in the minds of the people to improve their lot.

It must be recognized, however, that public expenditure is only a part of the over-all economic policy that a country may be adopting. Taxation, licensing and various policy instruments may aid public expenditure in achieving different objectives. Of course, if the things are ill-planned, different institutions may even work at cross-purposes. When therefore, the probable effects of public expenditure are mentioned, it is always understood that these effects have to be considered in the context of taxation and other measures being pursued by the government and that there is a coordination between different objectives and institutions.

Public Expenditure and Distribution

An important aspect of the market mechanism is the inequalities of income and wealth that arise on account of it and which through the institutions of private property and inheritance get widened with the passage of time. Furthermore, such income and wealth disparities not only spell a social and economic injustice, they also distort production and employment patterns.

Lesser inequalities of income and wealth, it may be claimed, contribute towards economic stability. It is generally recognized that marginal propensity to consume falls as income rises. As a result during the expansionary phase of a trade cycle, consumption demand tends to lag behind and causes a check on further expansion of

demand in the economy. Without such a check the upward movement of the trade cycle might develop into a real inflation. Similarly, during a depression, consumption refuses to dip below a certain level and as a result the economy is provided a firm base below which on account of a minimum demand it would not go. Furthermore, such a stability in the economy itself is helpful to economic growth. Private investment is affected, amongst other things, by safety and expected rates of return. With economic stability and expectation thereof, the risk of loss is reduced and this has, therefore, a healthy effect on the investment climate.

Welfare considerations also favour an equitable distribution of income and wealth. The purpose of an economic policy should be to contribute towards achieving the maximum social benefits. Though we cannot prove objectively that marginal utility of income falls as income increases, such a statement may be accepted on common-sense basis. If that is agreed, it follows that any movement towards equitable distribution of income and wealth would increase the aggregate satisfaction in the community. Lerner has shown that even if we do not know the exact way in which marginal utility of income falls with a rise in income and even if we cannot have inter-personal comparisons of utility, still a shift-towards equality would probably add to the aggregate satisfaction of the community.

Such a shift toward equality, of course, may be achieved through various forms of public expenditure especially those which are meant to help the poorer sections of the society. A number of welfare measures like free education, health, water and other facilities can be given a top priority. Numerous social security schemes can be adopted whereby people are entitled to old-age pensions, unemployment relief, sickness allowance and so on. Articles of common consumption like food can be subsidized, and the production of those which are in short supply can be taken up in the public sector. Left to market mechanism, the supply of 'merit goods' is likely to be insufficient. Public expenditure, through direct purchases, public production or subsidies can ensure that their supply is augmented to the desired extent. Similarly public expenditure, through appropriate subsidies and other 'purchase and stores' policy can encourage labour-intensive techniques of production which reduce unemployment and improve income distribution.

However, while proceeding with the programme of bringing about income and wealth equalities, certain aspects of possible interaction between distributive justice and other dimensions of the economy must be kept in mind. To begin with, poorer people may not be able

to enjoy fully the additional income because of ignorance, etc. But this argument is applicable only if suddenly large amounts of income start flowing to the poorer sections of the community. In an underdeveloped country (to whose poor people this argument could be directed); this argument does not apply because there is not enough to significantly improve the lot of everyone. Through income redistribution the poor masses can only feel a marginal relief. Even if there was a lot of income to redistribute, the desirability of reducing inequalities would not be disproved. It would only point towards the need for going slow in this direction, so that the poorer sections also get accustomed to higher standards of living.

The second consideration is that of the effect of equalities on production—through the will and capacity to work, save and invest. This is a controversial field, and clear-cut and widely acceptable generalizations are difficult to make. In a poor country, where the need to reduce inequalities is the greatest, savings potential is only with the higher income groups. With a big shift towards equalities, such a saving potential is much reduced especially because the poorer sections of the community are bound to consume away a major portion of their newly acquired incomes. The objective of economic equality, therefore, comes into conflict with that of economic growth. In other words, both will and capacity to save on the part of the members of the society are likely to suffer when a shift towards income and wealth equalities is made. An underdeveloped country, therefore, is faced with a difficult choice.

Thirdly, the distributive effects of public expenditure must be viewed in the context of its method of financing. For example, if the tax system of the country is regressive, it would militate against the distributive effects of public expenditure. Similarly, if public expenditure is financed through deficit financing, or through such borrowings as are inflationary in character, inequalities would widen. However, deficit financing to a certain extent need not generate inflationary pressures. Similarly, public borrowings out of genuine savings of the economy are expected to be only mildly inflationary. While the long-term solution of its economic difficulties cannot be had without economic growth, the problems of income distribution also cannot be postponed indefinitely. A via media, therefore, has to be worked out wherein both these objectives have to be pursued concurrently in a balanced manner. And to the extent the hitherto unexploited resources can be tapped, or foreign aid is received, the task of pursuing both the goals (of equitable distribution and growth) becomes less difficult.

13 THE PUBLIC BUDGET

INTRODUCTION

Each government plans to undertake various economic and other activities, and wants to pursue certain policies. These activities and policies have their financial counterparts in the form of collecting the necessary revenues and incurring expenditures. Accordingly, the government describes its intentions and policies which it would like to pursue in the coming period (usually a year) and draws up a financial plan[1] corresponding to this scheme of things. Such a financial plan describes in detail the estimated receipts and proposed expenditures and disbursements under various heads. Therefore, a budget enables the authorities to decide about each individual item of revenue and expenditure in the over-all context of the total plan.

The government cannot decide to go ahead with its decisions regarding taxation, borrowings, expenditure and other fiscal measures at random. All these decisions and policies are interconnected and must form a part of the over-all set of objectives which the government plans to pursue. The whole approach has to be quite systematic. In general, a budget shows the financial accounts of the previous year, the budget and revised estimates of the current year, and the budget estimates of the coming year. Furthermore, the estimates of the coming years are split up into two parts—those based upon the assumption that the current year's taxes and their rates, and expenditure policy, would continue, and those based upon the proposed changes therein. A budget, in this sense, becomes both a description of the fiscal policies of the government and the financial plans corresponding to them.

In a budget, it is quite possible that some revenues happen to be earmarked for certain specific expenditures. For example, certain projects might be financed through public borrowings and collections through betterment levies or special assessments might be earmarked to meet the cost of these projects. In India, during the early 1970's

[1]The word budget has been derived from the French word 'bougette' which means a small bag. It symbolizes a bag containing the financial proposals. Hence the term 'opening the budget' The use of the term budget for the annual financial plans of the government dates back to 1733.

certain sums were collected which were earmarked for helping the refugees from Bangladesh. Similarly, on the expenditure side of the budget, certain amounts may be contractual and legal payments which cannot be avoided such as interest payments on loans, repayment of loans, payments arising out of satisfaction of certain court decrees, amounts falling due for payment on account of salaries, pensions, provident funds and so on.

A budget may be presented in parts In India, for example, railway finances form a part of the Central Government Finances, but the railway budget is presented separately from the main budget of the Central Government. However, the totals of the receipts and expenditure of the railways are incorporated in the Budget Statement of the Government of India. Similarly, the budget may be divided on the basis of different layers of the government. In a big country, such as India, it is most likely that in addition to the Central Government, there will be various state and local governments. Each layer of the government prepares, passes and implements its own budget Of course, some intergovernmental transactions also take place and depending upon the legal and accounting procedures such transactions may form a part of the budget at one layer or the other. The net effect of the fiscal policy of the government depends upon the collective budgeting of all the layers of the government

There are two other reasons also on account of which the budget of the year may be split up. The first is the political cause. When, technically, the existing executive government may or may not continue for the full year on account of the fact that elections are due, then a 'lame duck' budget is presented -a budget which covers only a part of the year. Such a budget enables the next executive to formulate its own budget for the rest of the year. The second cause is an economic one which may result in a *supplementary budget*. It is not always possible to foresee and provide for all emergencies (such as a war, or natural calamities, etc.) which will necessitate an extra expenditure. Similarly, for some reason or other, the revenue receipts may fall short of the expected ones. In these circumstances, the authorities may find it fit to have a supplementary budget.

A *good budget* is one which is able to satisfy certain conditions and is formulated according to certain well drawn principles. One such principle is that the budget should be accompanied by an account of the performance of the fiscal policies and programmes of the government during the previous year. This provides a necessary basis for deciding as to what was to be done, what has been accomplished and what more should be aimed at and in what directions.

The budget proposals should also be accompanied by an analytical description of the current economic situation of the country as also the position of the Treasury. The budget proposals become far more meaningful in the light of the above mentioned accounts and descriptions. And they enable the legislature and the public to see the relevance or otherwise of the budget proposals and help the legislature in taking a more objective and rational stand in this connection. Furthermore, the proposals themselves should be as clear as possible. They should be clearly comprehensible so that a correct judgment can be formed as to the way in which the budget is expected to function in the coming year. Accordingly, detailed budget proposals must accompany the proposals under major heads of receipts and expenditure. There should also be various statements which highlight the particular aspects of the budget.

An economic and functional classification of the budget will depict its role in the working of the economy in a much clearer way than would be the case with only financial proposals under various departments, and so on. Similarly, though complete accuracy cannot be expected, financial estimates of a good budget should not be wide off the mark. They should be fairly close to the actuals under normal circumstances. A budget should reflect the over-all policy and purpose of the government and should be so designed as to help the society move nearer to the chosen goals.

In India, the actual financial statement of the Government of India is called the Budget Statement. Article 112 of the Constitution of India states that "an annual financial statement" will be placed before both Lok Sabha, and Rajya Sabha, while Article 202 of the Constitution states that a similar financial statement for each State will be placed before the Legislature of that State.

The Government Accounts (both the Centre and the States) are kept in three parts viz., (*i*) Consolidated Fund, (*ii*) Contingency Fund, and (*iii*) Public Account. All the funds which belong to the government go to the Consolidated Fund. All the revenues which the Government realizes, the loans raised by it, or the receipts by way of repayment of loans, etc., go to this Fund. Similarly, all expenditures are also incurred out of this Fund. No amount can be spent from the Consolidated Fund of India without the sanction of Parliament, barring certain expenses specified in the Constitution and charged to the Fund (such as the salaries of the Judges of the Supreme Court and Auditor and Comptroller General of India). These expenses are included in the Budget but are not put to vote in Parliament. Similarly, tospend any money out of a State Consolidated Fund, the sanction

of the State Legislature is needed. The Contingency Fund consists of those moneys which are put at the disposal of the Governments to meet those expenses which cannot be delayed. A prior sanction of the Parliament (for spending an amount out of the Contingency Fund of the Central Government) or of a State Legislature (for spending an amount out of the State Contingency Fund) is not needed. However, any such expenditure has to be approved later by the Parliament or the State Legislature as the case may be and the Contingency Fund is to be replenished. At present, the corpus of the Contingency Fund of the Government of India as authorised by Parliament stands at Rs 30 crores.

Funds in the Public Account are those which do not belong to the Government. This Fund includes funds collected on account of provident funds, small savings, etc. To make payments out of the Public Account Fund, the sanction of Parliament or the State Legislature is not needed. In India, both the Central and State Budget Statements show the receipts and payments under the above mentioned three accounts separately. (For further details see the section on Economic Classification of Budgets.)

The Kinds of Budgets

In olden days, a budget was more or less only a statement of the financial plans of the government. But now the importance of the government activities is fully recognized. Government's financial activities contribute a major portion to the flow of funds in the economy and the government's fisçal policy together with the financial flows has a wide impact on the working of the economy. Accordingly, now various kinds of budget estimates are presented to indicate the manner in which the budget would be affecting the economy. The actual role of the government transactions in the life and working of the economy cannot be underestimated because of the immense impact which they have. As Pigou said, though "money is practically always the medium of public finance, it is not the thing in which it really deals. The money is merely a ticket embodying command over services and goods. It is those, not the money that represents them, which constitute the real object of all transactions."[2]

Before, however, we move on the kinds of budgets from the economic standpoint, let us first distinguish between the *executive* and *legislative budgets*. A legislative budget is the one which is prepared and adopted by the legislature directly or through its committees. An

[2]A.C. Pigou, *A Study in Public Finance*, p. 2.

executive budget, on the other hand, is the one which is prepared by the executive branch of the government. Such a budget is also normally passed and adopted by the legislature but the initiative is in the hands of the executive. It is generally believed that an executive budget is preferable to legislative one.

Firstly, the executive is better equipped to estimate properly the various probable receipts and the required expenditures. The legislature is not likely to be able to do so efficiently.

Secondly, it is the executive which will be responsible for the execution of the budget in any case. It is not desirable to just thrust certain estimates and figures upon the executive and ask it to realize the targets especially if these estimates are highly unrealistic.

Thirdly, when the executive prepares the budget, it can be more directly held responsible for any shortcomings and lapses.

Multiple and Unified Budgets. In USA, there was a tradition to divide the Budget into parts, and present each part in a way as would make it possible to evaluate the specialized functions of the Government. But it is now felt that what is needed is a unified budget because it is the total effect of a budget which is more relevant and that can be seen only in a unified budget. This is basically so at times of emergencies. The true results of the fiscal operations of the government budget get scattered in the case of multiple budgets and have to be traced out through various documents, etc. Probably the best course is the one in which along with the unified budget, important sub-portions are classified, and presented separately. For India, along with the main budget, we also get the 'Plan Budget'.

Conventional and Cash Budgets. In USA, another distinction is made between the conventional (or administrative) budget and the cash budget. Apart from the minor differences, the main difference between the two is that in the conventional budget, revenue and expenditure are shown on accrual basis and those flows of funds are excluded which do not 'belong to the government. In this way, the conventional budget is stated to harbour two deficiencies as far as its role in the flows of funds in the economy and therefore its effects on the economy are concerned.

Firstly, as noted above, it runs on accrual basis. As receipts and payments falling due in a period generally differ from the ones actually made, there is a distortion of the actual picture of the flow of funds caused by governmental activities.

Secondly, the actual handling of various cash receipts and payments, though not belonging to the government, also have their profound role in the flow of the funds and the effects thereof. Thus, the conven-

tional budget always presents an inadequate picture of the governmental activities. In the cash budget, on the other hand, all the flows of funds to and from the government on actual payment basis are shown, inclusive of funds which are not 'owned' by the government. Cash budget, therefore, is invariably larger than the conventional budget and a better representative of reality.

Revenue and Capital Budgets. In many countries, the budget is divided into revenue (current) and capital accounts. Revenue account covers those items which are of recurring nature; while capital account covers those items which are in the nature of acquiring and disposing of capital assets. Various arguments are put forth to justify such a division of the budget into two parts. It is maintained that every economic unit must distinguish between current expenses and those incurred for acquiring capital assets. Current expenses are equivalent to consumption; while acquiring of capital assets is not. It is only when these capital assets depreciate that real expenditure takes place in the sense of consumption. This is the rationale because of which private commercial units do not count the amounts spent on the acquisition of capital assets as a part of current expenses for the year. It is only the depreciation part that is so counted. It is argued that the government should also follow the same practice—and more so when for taxation purposes it is the practice of the business houses which is honoured. This argument has some logic in it.

Another argument in favour of the division of the budget between capital and revenue accounts is however quite flimsy. It is maintained that through such a division the government can follow a good working rule, namely, deciding that all the current expenses would be met through taxation while all the capital expenses would be met through borrowings. It must be noted that such a policy approach can be quite vague. What is needed is an over-all fiscal policy framework and the decision to levy more taxes or borrow, etc., should be taken in the context of the totality of the fiscal policy. Any kind of pinning down of various expenses to different forms of revenue receipts would be undesirable.

In India, the Constitution demands that the budget must distinguish expenditure on Revenue Accounts from other expenditure. Accordingly, the budget is necesarily presented into two parts, namely, Revenue Budget and Capital Budget. Revenue Budget consists of the *revenue receipts*—both tax-revenue and non-tax-revenue—and the expenditure met out of revenue receipts. The non-tax-revenue receipts include revenue from currency, coinage and mint, interest receipts, dividends, profits, revenue from general services (such as police, jails,

supplies and disposal, public works, etc.), revenue from social and community services (such as education, health, housing, broadcasting, and so on), and revenue from economic services (such as agriculture and allied services, industry and mines, transport and communications, etc.).

Capital Account receipts, on the other hand, include *market loans*, borrowings from the Reserve Bank of India, etc., through the sale of Treasury Bills[3], loans from foreign governments and institutions, and repayment of loans by State Governments and others to the Central Government. Capital disbursements would include expenditure on acquisition of various physical assets like land, buildings, machinery and equipment, investments in shares and debentures, and loans to State Governments and other bodies. The Capital Budget also incorporates the transactions in the Public Account.

The division between Revenue and Capital account for the State Budget is similar to that of the Government of India Budget, with some obvious differences. For example, the State Governments cannot borrow from foreign governments and agencies. They do not have any revenue from currency, coinage and mint. They borrow large sums from the Government of India, but they do not borrow as much from the market or from the Reserve Bank of India. Similarly, particular kinds of tax-revenues will differ on account of different lists according to which the State and Central Governments can impose taxation. The State Governments also receive grants-in-aid from the Central Government and get a share from various taxes levied and collected by the Centre.

In India, in addition to the division of the budget into Revenue and Capital Accounts, the Plan Budget is also presented. The Plan Budget is a document which shows the budgetary provisions for important projects, programmes and schemes included in the Central Plan. This document gives the details of the Budgetary support for the Central Plan by sectors of development, including the Central assistance for State and Union Territories Plans. Furthermore, extra Budgetary resources for the Central Plan are also shown. The break-up of the proposed outlays between General Services, Social and Community Services, and General Economic Services, is shown together with various physical targets wherever possible. Such a scheme of things, therefore enables us to have a proper appreciation of the Plan. This is made further possible with the help of the Performance Budgets (we

[3]Borrowings from the Reserve Bank of India through the sale of long-term securities is considered a part of the 'market loans.'

shall discuss these later) which different ministries and departments present. It may be added that in India, plan expenditure covers only that portion of the total expenditure which is directed to finance the schemes specifically initiated under the given plan or which are the spill-over of the previous plan/plans. Those schemes which are completed would also require maintenance and other running expenditure in future; but such expenditure is counted as non-plan expenditure with the result that over time, the non-plan expenditure keeps on increasing automatically.

ECONOMIC AND FUNCTIONAL CLASSIFICATION OF BUDGETS

The budget plays a very important role in the flow of funds in the economy. It also has important effects on the working of the economy not only through the flow of funds but also through various fiscal policies and measrues. Accordingly, the "ability of government authorities to form a clear picture of the impact of their transactions on the economy has become a requisite for making fiscal and economic policy decisions."[4] If, therefore, a budget is formulated in terms of the sources from which various receipts would be had and the departments and ministries etc., upon which these funds would be spent, then it would be a very incomplete picture of what the budget *can* do and what the budget *is* doing in the economy. The very magnitude of the modern budget makes it an important policy tool which the authorities should use to the advantage of the economy. And with increasing size of the government budget, the need for such a classification is increasing. In countries like India, where the government plays a leading role in effecting saving, investment and capital formation, it becomes all the more necessary that the role of the budget in the economic life and progress of the society should be judged as accurately as possible. It is therefore, essential that the government expenditure and the mode of its financing should be presented in *economically and functionally significant categories*. Classification of the expenditure and the mode of its financing in terms of economic categories (expenditure on wages and salaries, receipts from market borrowings and the like) will be called an *economic classification* of the budget. This classification enables us to gather information regarding generation of savings, investment, consumption, creation of financial assets and

[4]UN Department of Economic and Social Affairs, *Reclassification of Government Expenditure and Receipts in Selected Countries*, New York, 1958, Preface.

liabilities, etc., from various budgetary items. ***Functional classification***, on the other hand, refers to the types of functions (or tasks) which the government performs or the services, which it provides, such as, economic services, social services, defence services and the like. An economic or a functional classification cuts across the departments and agencies and presents a picture of what the government is doing in various spheres such as capital accumulation, health education, and so on.

Thus, economic and functional classification of the budget can prove very helpful in arriving at various decisions considered appropriate for achieving different goals in the economy. The usefulness of this approach is further enhanced in view of the increasing role which the authorities are anxious to assume in bringing about economic stability, accelerating the process of economic growth and imparting distributive justice.

The traditional approach towards budgetary accounting was determined by the end objectives of establishing an effective legislative control over the executive, and to meet the requirements of fiscal management. To this end, therefore, accounts were classified into categories corresponding to individual ministries, departments and sections; and within each, there were further 'heads' and sub-heads', etc. But there was a lack of correspondence between the purpose and the account head and this approach failed to provide the necessary information required for the formulation of fiscal policies. As we know, quite often expenditure for a particular purpose is incurred by different agencies and such an expenditure is not properly distinguished from certain other expenses which an agency might be undertaking. Nomenclature of various heads would response to different items of expenditure in different departments or ministries. But the accounting system based upon the traditional approach is well designed to meet the ends of legislative control and to see that the spending agencies do not transgress the rules laid down. It is an excellent aid to the government auditors and an effective check against misappropriation of funds and other fraudulent practices.

However, such a system, though still very useful for the purposes of legislative control and auditing, is totally inadequate for gauging the effects of various budgetary policies and operations and for devising improvements therein. It fails to yield the necessary information for economic analysis, and its inadequacy becomes more prominent as the trading and productive activities of the government expand and as the public sector assumes greater importance. These days, the primary objective of budgetary policies and operations is

to achieve the maximum possible benefit to the society. And to that end a system of economic and functional classification of the budget on the one hand and the introduction of programme and performance budgeting on the other (to be discussed in the next section) are very essential. Any appropriate functional classification it very helpful in having an efficient programme and performance budgeting, especially because in the latter a number of spending agencies are involved between which an effective coordination is needed and because the formulation of programmes and assessing their performance would mostly cover multibudget periods. In India, functional classification of the budget has been there in a way in the sense that items of expenditure were grouped under important major heads depicting particular types of functions such as defence services. But such a classification was not basically *meant* to reflect the types of functions the government was performing. A meaningful functional classification would be a different one. And with the expansion of the governmental activities, the older classification lost a good deal of its earlier functional relevance. For example, the head 'miscellaneous' would now cover very important and divergent items when we consider different spending agencies. From the angle of usefulness, "the budget accounts should be so compiled as to depict to the extent practicable, the total expenditure of Government on its basic functions, programmes and activities."[5]

It need not be emphasized that there is no single system of economic or functional classification which would be suitable for every country. Budgetary classification is not an end in itself. It is only an aid in assessing the magnitude of various categories and their relative importance. A proper meaningful information which can be devised from a classification will also depend upon the way in which various categories are defined. It is, however, generally agreed that a desirable economic classification would be the one which conforms to a system of national economic accounts capable of depicting the national activities of income generation and its utilization for consumption and capital formation purposes. Such a budgetary classification should enable us to judge the contribution which the *government budget* makes to the activities of consumption, capital formation and income generation. Similarly, a functional classification may be attempted in terms of various types of government expenditure. An important classification would be in terms of investment expenditure and con-

[5]Administrative Reforms Commission, *Report of the Study Team—Accounts and Audit*, September 1967, para 5.1.

sumption expenditure. Investment expenditure would be that which leads to the creation of physical capital assets in the country. Consumption expenditure on the other hand is that expenditure which does not lead to the creation of physical capital assets and would include expenditure on goods and payment of wages etc. Similarly, it would be quite useful, in the context of a developing country like ours, to have a functional classification between developmental and non-developmental expenditure. This classification cuts across the first one since developmental expenditure may be consumption expenditure (such as in terms of providing health facilities) or it may not be. In India, we are also familiar with the classification between plan and non-plan expenditure. In every plan, there are various schemes and projects for which funds are provided. All such expenditure is plan expenditure while the rest is non-plan expenditure. Such a plan expenditure may in turn be consumption expenditure or investment expenditure, and it may be developmental expenditure or non-developmental expenditure.

Sweden was one of the first countries to adopt a cross-classification which was based upon the recommendations of a committee of experts on financial statistics set up in 1940. Some of the recommendations of this committee were adopted by the Accountant General of Sweden in the year-book of 1948 and a regular publication of the two-way table (which, we shall see below, is an economic-cum-functional classification) started with the year-book of 1950-51. An increasing awareness on the part of the authorities to reform public budgetary reporting system so as to meet the emerging requirements of economic and social analysis and obligations led to several regional workshops on the problems of budget classification under the auspices of the UN. The first such workshop was held in September 1953 in Mexico City and the second and third in Bangkok in September 1955 and September 1957 respectively. The spadework for these workshop was done by the UN Bureau of Economic Affairs (Fiscal and Financial Branch). These workshops provided a good deal of impetus to the process of reclassification of budgets.

A need for introducing an economic classification was at once realized in India. The budgetary classification of accounts, it may be pointed out, was even then quite advanced in our country though in its general structure it was quite old which led Dr M. H. Gopal to say that "In fact, there has been little development in presentation, bet-

ween say, Strachey's budget of the 1870s and that of today."[6] It was being presented into separate current and capital accounts—a practice which our Constitution has continued under Article 112(1). The basic pattern in the Government of India budget is to record all transactions under prescribed major heads subdivided into minor heads and subheads. The major heads are themselves grouped under various sections. And it is with figures of expenditure and receipts arranged under sections and major subheads that they are presented to Parliament together with Demands for Grants. A ministry, for example, presents a Demand for its own expenditure and separate demand for each of the major organisation under its administrative control. Thus, a nucleus of an appropriate classification was there with us when we decided to go ahead with economic and functional classification. Of course, the original in itself was also reflecting an increasing need for reformation on account of the fact that in the course of time the organisational pattern had undergone a substantial change whereas the heads of accounts had remained relatively unchanged. But still the budget accounts were in a form more suitable for reclassification than those of many other countries.

During 1956, *economic classification* of the Government of India budget was undertaken by the Economic Division of the Ministry of Finance and the results were submitted almost simultaneously with the 1957-58 budget. This classification covers Central Government transactions and the departmental commercial undertakings. Functional classification of the budget was introduced with the budget of 1967-68 together with an economic-cum-functional classification with a view to enhancing the utility of economic classification. Such a two-way economic-cum-functional classification was recommended to the governments in the Report of the above mentioned workshop in 1955. The Report had stated that such a classification was a very "useful means of analyzing the development element in public expenditure and studying its implications." It had further maintained "that a statement in this form is perhaps the clearest and most enlightening way of presenting information to the general public about government expenditure and improving the citizens understanding of what the government is doing." The cross-classification by economic character and purposes is a well-established tool of statistical analysis, which has also found its

[6]M. H. Gopal, *Studies in Indian Public Finance*, Rao and Raghavan, Mysore, 1963, p. 118.

uses in the field of public finance."[7] Detailed principles of classification were suggested in "A Manual for Economic and Functional Classification of Government Transactions" prepared by the Department of Economic Affairs of the UN in 1959. This Manual groups government expenditure under five heads: General Services, Community Services, Social Services, Economic Services and Unallocable. The Indian functional classification is in somewhat modified form as we shall see.

As pointed out above, economic classification of the Government of India budget started with the budget for 1957-58 and with effect from the budget for 1967-68 a functional classification was also added to it. As yet, however, we do not have an economic-cum-functional classification of *combined* State and Central Government budgets though various State Governments are presenting economic and functional classification of their respective budgets. Let us start with the economic classification of the Government of India budget. This classification has six accounts or tables covering the following:

Account 1: Transactions in commodities and services, and transfers: Current Account of Government Administration.

Account 2: Transactions in commodities and services, and transfers: Current Account of Departmental Commercial Undertakings.

Account 3: Transactions in commodities and services, and transfers: Capital Account of Government Administration and Departmental Commercial Undertakings (Combined).

Account 4: Changes in Financial assets: Capital Account of Government Administration and Departmental Commercial Undertakings.

Account 5: Changes in financial liabilities: Capital Account of Government Administration and Departmental Commercial Undertakings.

Account 6: Cash and Reconciliation Account of Government Administration and Departmental Commercial Undertakings.

This classification system is designed in a way which enables us to link it with a system of national income and expenditure accounts depicting the activities associated with the generation of national income and capital formation. It, therefore, provides a breakdown of Government expenditure into consumption and capital formation,

[7]UN Department of Economic and Social Affairs, *Reclassification of Government Expenditure and Receipts in Selected Countries*, New York, 1958.

and the impact which the Government expenditure has upon the rest of the economy. Furthermore, this classification also provides an information concerning financial assets and liabilities and is very helpful in assessing the changes in the composition and ownership of financial assets as also the borrowing and lending transactions of the Government. An analysis of financial transactions also helps us in assessing the indirect contribution which the budgetary operations make to the capital formation by other agencies. These six accounts are further based upon a distinction between transactions in goods and services on the one hand and financial transactions on the other. The transactions in goods and services and transfers cover the first three accounts while the financial transactions cover the last three accounts. Further, the first category of transactions (namely that of transactions in goods and services, and transfers) is further split up into current transactions (vide Accounts 1 and 2) and capital transactions (vide Account 3). The current transactions are themselves divided into the transactions of the Government Administration and those of the departmental commercial undertakings (Accounts 1 and 2).

These accounts are so designed as to reflect the Government transactions with the rest of the economy. For this reason, therefore, these accounts have been imparted certain characteristics. For example, in our Budget, Demands for Grants are shown on a gross basis. The recoveries, if any, are treated as a reduction in expenditure in the totalling of the Demands and the total receipts and expenditures in the Financial Statement are net of all recoveries including aid received in kind. In economic classification, Government expenditures are shown *gross* (and not net) of recoveries from the rest of the economy. This approach is considered more suitable for depicting the totality of Government transactions with the rest of the economy. Similarly, another characteristic of these accounts is the non-inclusion of inter-departmental or inter-account transactions, as also transactions pertaining to various 'funds' shown in the Public Account of India. From the point of view of sanctioning and Parliamentary control, these details are often necessary, but not for the purpose of depicting the transactions of the Government with the rest of the economy.

Let us now take up the individual accounts, comment on their general rationale and important items, and illustrate them for the years 1976-77 (A/cs), 1977-78 (R.E.), and 1978-79 (B.E.).

Account 1

This Account covers the transaction in goods and services and

transfers of Government Administration on the Current Account. The departmental commercial undertakings have been excluded from here and dealt with in the next Account because these undertakings (like other productive sectors of the economy) are engaged in the production of goods and services and their sale to the rest of the economy. On the other hand, the administrative departments are basically consumption departments only and have a very limited income of their own (such as from the ownership of property). This Account, accordingly, indicates the direct consumption by the administrative departments of the Government. This consumption expenditure obviously consists of purchases of commodities and services plus wages and salary payments plus transfers in the form of subsidies, pensions, scholarships, reliefs etc. These expenditures are met by the Government by collecting tax and other receipts and by income from enterprises and property. The excess of revenue over expenditure gives the savings (item 4, *i.e.*, item 9 minus item 3) of the Government which can be utilized for capital formation.

It may be noted that wages and salaries component (item 1.1) of capital outlay is taken as one-third of the works expenditure (the balance two-third being taken as purchases of commodities and services). Similarly, 50% of the expenditure on 'repairs and maintenance' and 'lump sum provisions' is taken as wages and salaries. Contributions to UN and other international organisations are treated as purchases of services. Similarly, defence capital outlay is treated as current expenditure. Those transfers which are intended to assist capital expenditure are excluded from this Account, and only the current transfers appear here. Also note that (item 2.1) interest payments here appear on gross basis. Interest charged to departmental commercial undertakings appear in Account 2 which is the current account of these undertakings. Grants (item 2.2) cover statutory grants, plan grants and non-plan grants but excepting those which are meant to assist capital formation. Starting with the Fourth Plan, the States and the Union Territories have received block grants and these have been divided between current and capital grants in the ratio of 50:50. Other current transfers (item 2.3) include subsidies, pensions, scholarships, stipends, prizes, famine and other relief payments etc.

It is hypothesized that the current transfer receipts of the Government come out of income, while capital receipts are paid by the rest of the economy out of its capital. Accordingly estate duty and gift tax are treated as capital receipts and do not appear in this Account. Income from property and enterprises (item 7) includes profits of

departmental and non-departmental commercial undertakings transferred to the administration plus profits of the Reserve Bank of India. In item 7.4 (interest receipts), interest received from departmental commercial undertakings is omitted since it appears in Account 2.

Account 2

This Account is corresponding to Account 1 and covers the departmental undertakings. Their role is to be distinguished from administrative receipts and expenditures in the sense that these undertakings sell their goods and services to other sectors of the economy and their expenses constitute intermediate expenditures which enter into the prices of goods and services. Basically, this Account is profit and loss account of these undertakings. Those Government enterprises the transactions of which do not form a part of Demands for Grants and the Budget are excluded here.

The items in this Account do not need any separate comments. And it would be seen that the sum total of retained profit (item 8), depreciation provision (item 6) and savings of the Government administration (item 4 of Account 1) constitute the gross budgetary savings available for capital formation.

Account 3

This account covers the total capital outlay and represents physical sset formation by the Government and the departmental commercial undertakings. A distinction between capital formation by the administration and by departmental commercial undertakings is of little use and therefore both have been combined into one Account. Further, the physical asset formation here is shown on gross and not net basis. The deficit on all transactions appears as a balancing item (item 7) in the Account and it measures the change in Government's indebtedness to the rest of the economy. Individual items in this Account are easy to follow.

Account 4

This Account describes transactions in financial assets namely investment in share capital of industrial and commercial concerns and loans and advances to the rest of the economy. Loans have been divided into those meant for capital formation and those fo other purposes. Investment in share capital and loans for capital formation show the extent to which the Government indirectly promotes capital formation in the rest of the economy. The balancing item (item 8)

TABLE 13.1

Account 1: Transactions in Commodities and Services and Transfers: Current Account of Governmental Administration

(*Rs crores*)

Expenditure	*1976-77 A/cs*	*1977-78 R. E.*	*1978-79 B. E.*
1. Consumption Expenditure	3605.9	3819.2	4139.9
1.1 wages and salaries	1835.2	1913.2	2044.4
1.2 commodities and services	1770.7	1906.0	2095.5
2. Transfer payments	3944.7	4684.9	5275.7
2.1 interest	1194.8	1390.0	1690.2
2.2 grants			
(*a*) to States and Union Territories	1252.1	1456.4	1745.1
(*b*) to Local Authorities	22.1	22.7	25.8
(*c*) to others	358.3	446.3	576.1
2.3 Other current transfers			
(*a*) subsidies	947.0	1171.6	1018.8
(*b*) pensions	119.6	138.9	157.0
(*c*) others	50·8	58.7	62.7
3. Total expenditure (1)+(2)	7550.6	8504.1	9415.6
4. Savings on current account	456.5	838.2	405.2
5. Total	8007.1	8842.3	9820.8

Revenue	*1976-77 A/cs*	*1977-78 R. E.*	*1978-79 B. E.*
6. Tax receipts	6556.3	7081.0	8001.9
6.1 taxes on income and wealth	1658.4	1790.1	1926.1
6.2 taxes on commodities and transactions	4897.9	5291.1	6075.8
7. Income from property and enterprises	1245.2	1429.6	1499.4
7.1 profits transferred by departmental Commerical undertakings	40.5	52.8	52.3
7.2 dividends paid by non-departmental commercial undertakings	41.3	78.1	69.9
7.3 profits of the Reserve Bank of India	190·0	200.0	200.0
7.4 interest receipts:			
(*a*) from States and Union Territories	389.9	524.0	575.0
(*b*) from others	468.3	535.5	530.5
7.5 others	115.2	39.2	71.7
8. Fees and Miscellaneous	205.6	331.6	319.5
9. Total	8007.1	8842.3	9820.8

Source: Ministry of Finance, Government of India, *An Economic and Functional Classification of the Central Government Budget*, 1978-79.

TABLE 13.2

ACCOUNT 2: TRANSACTIONS IN COMMODITIES AND SERVICES AND TRANSFERS: CURRENT ACCOUNT OF DEPARTMENTAL COMMERCIAL UNDERTAKINGS

(Rs crores)

Expenditure	*1976-77 A/cs*	*1977-78 R. E.*	*1978-79 B. E.*	*Receipts*	*1976-77 A/cs*	*1977-78 R. E.*	*1978-79 B. E.*
1. Wages and salaries	985.4	1030.8	1100.9	10. Gross sales proceeds	3121 0	3434 4	3680 6
2. Pension payments	55.2	64.4	65.7	(*a*) railways	2045.7	2141 8	2230 3
3. Commodities and services	642.7	782.7	834.2	(*b*) manufacturing activity of railways' workshops and production units	302 2	341 7	371 8
4. Repairs and maintenance	725 4	768.3	830 4	(*c*) P & T	619 3	690 4	778 7
5. Interest	247.2	268.3	283 9	(*d*) others	153 8	260 5	299.8
6. Provision for depreciation	187 0	199 3	215.0	11. Interest receipts	3.7	6 0	10.4
7. Profits transferred to the Current A/c of the Government (Administration)	40.5	52.8	52 3				
8. Retained profits of departmental commercial undertakings	241 3	273.8	308.6				
9. Total	3124.7	3440 4	3691 0	12. Total	3124 7	3440 4	3691.0

Source: Ministry of Finance, Government of India, *An Economic and Functional Classification of the Central Government Budget*, 1978-79.

TABLE 13.3

ACCOUNT 3: TRANSACTIONS IN COMMODITIES AND SERVICES AND TRANSFERS: CAPITAL ACCOUNT OF GOVERNMENT ADMINISTRATION AND DEPARTMENTAL COMMERCIAL UNDERTAKINGS

(*Rs crores*)

Disbursements	*1976-77 A'cs*	*1977-78 R.E.*	*1978-79 B.E.*
1. Gross fixed capital formation	1089.7	1272.5	1463.6
1.1 buildings and other construction	611.4	726.4	889.0
(*a*) new outlay	526.1	624.7	772.6
(*b*) renewals and replacements	85.3	101.7	116.4
1.2 machinery and equipment	478.3	546.1	574.6
(*a*) new outlay	397.2	453.2	483.2
(*b*) renewals and replacements	81.1	92.9	91.4
2. Increase in inventories	22.1	—31.0	165.8
2.1 work stores	—30.4	34.5	59.1
2.2 fertilizer transactions	52.5	—65.5	106.7
3. Capital transfers	501.9	786.6	1053.2
3.1 grants for capital formation			
(*a*) to States and Union Territories	340.0	583.6	759.9
(*b*) to non-departmental commercial undertakings	57.6	75.8	99.8
(*c*) to Local Authorities	8.2	6.8	11.4
(*d*) to others	30.6	41.7	89.6
3.2 gratuities and commuted value of pensions	24.8	29.8	32.0
3.3 Other capital transfers	40.7	48.9	60.5
4. Total	1613.7	2028.1	2682.6

Receipts	*1976-77 A/cs*	*1977-78 R.E.*	*1978-79 B.E.*
5. Gross savings	884.8	811.3	928.8
5.1 saving on current account (Administration)	456.5	338.2	405.2
5.2 retained profits of departmental commercial undertakings	241.3	273.8	308.6
5.3 depreciation provision	187.0	199.3	215.0
6. Capital transfers	288.1	360.2	391.4
6.1 gift tax and estate duty	7.9	6.9	6.9
6.2 foreign grants	271.2	344.2	376.9
6.3 other capital receipts	9.0	9.1	7.6
7. Balance : Deficit on all transactions in commodities and services and transfers	440.8	856.6	1362.4
8. Total	1613.7	2028.1	2682.6

Source: Ministry of Finance, Government of India, *An Economic and Functional Classification of the Central Government Budget*, 1978-79.

TABLE 13.4

ACCOUNT 4: CHANGES IN FINANCIAL ASSETS: CAPITAL ACCOUNT OF GOVERNMENT ADMINISTRATION AND DEPARTMENTAL COMMERCIAL UNDERTAKINGS

(*Rs crores*)

Outgoings	*1976-77 A/cs*	*1977-78 R.E.*	*1978-79 B E.*
1. Investment in shares	888 9	1051.7	1202.6
1.1 of Government concerns	865.5	1027.6	1172.3
(*a*) financial concerns	9 6	17.7	22 0
(*b*) others	855 9	1009.9	1150.3
1.2 of other concerns	23 4	24.1	30 3
2. Loans for capital formation	2553 9	2897.4	3254 2
2.1 to States and Union Territories	1183.9	1674.4	2069 7
2.2 to Local Authorities	82.8	84 8	98 2
2.3 to non-departmental commercial undertakings	1260 2	1102.9	1052 0
(*a*) financial concerns	268.9	320.1	324 5
(*b*) others	991.4	782 8	727 5
2.4 to others	27.0	35 3	34 3
3. Other loans	481.9	884.7	712 0
3.1 to States and Union Territories	146.8	146 0	150.1
3.2 to Local Authorities	0.5	0.4	1.7
3.3 to non-departmental commercial undertakings	87 3	178 6	59 7
3.4 to foreign governments	184 8	498 0	445 6
3.5 to others	62.5	61.7	54 9
4. Subscriptions to international financial organisations	60 1	8.1	247 5
5. Net purchase of gold and silver	1.0	2 0	2 2
6. Total	3985 8	4843 9	5418 5

Incomings	*1976-77 A/cs*	*1977-78 R E.*	*1978-79 B.E.*
7. Repayment of loans	740 0	1383.8	158
7.1 by States and Union Territories	446.3	660 0	5 7 735.0
7.2 by others	293.7	723 8	855.7
8. Balance: net increase in financial assets	3245.8	3460 1	3832.8
9 Total	3985.8	4843.9	5418.5

Source: Ministry of Finance, Government of India, *An Economic and Functional Classification of the Central Government Budget*, 1978-79.

TABLE 13.5

ACCOUNT 5: CHANGES IN FINANCIAL LIABILITIES: CAPITAL ACCOUNT OF GOVERNMENT ADMINISTRATION AND DEPARTMENTAL COMMERCIAL UNDERTAKINGS

(*Rs crores*)

Outgoings	*1976-77 A/cs*	*1977-78 R.E.*	*1978-79 B.E.*	*Incomings*	*1976-77 A/cs*	*1977-78 R.E.*	*1978-79 B.E.*
				5. Market borrowings	1122.6	1311.8	1830.0
1. Repayment of long-term rupee debt	278.1	129.3	180.2	6. External debt	1491.5	1076.4	1345.4
2. Repayment of foreign debt	370.0	438.6	400.1	7. Small savings (net)	413.3	440.0	460.0
				8. State provident funds (net)	183.6	188.9	231.3
3. Balance: Net increase in financial liabilities	3214.1	4043.9	5194.2	9. Public provident fund (net)	11.9	14.0	17.0
				10. Deposits of non-government provident funds	215.1	250.0	225.0
				11. Special borrowings from the Reserve Bank of India	48.00	130.0	125.0
				12. Sales of treasury bills (net)			
				12.1 special treasury bills	56.3	2.8	239.3
				12.2 other treasury bills	—341.8	702.0	1049.0
				13. Miscellaneous capital receipts (net)	229.7	495.9	252.5
4. Total	3862.2	4611.8	5774.5	14. Total	3862.2	4611.8	5774.5

Source: Ministry of Finance, Government of India, *An Economic and Functional Classification of the Central Government Budget*, 1978-79.

TABLE 13 6

ACCOUNT 6 CASH AND CAPITAL RECONCILIATION ACCOUNT OF GOVERNMENT ADMINISTRATION AND DEPARTMENTAL COMMERCIAL UNDERTAKINGS

(*Rs crores*)

Outgoings	*1976-77 A/cs*	*1977-78 R E*	*1978-79 B E*	*Incomings*	*1976-77 A/cs*	*1977-78 R E*	*1978-79 B E*
1. Deficit on all transactions and transfers—balancing item of A/c 3	440 8	856 6	1362 4	5 Net increase in financial liabilities—balancing item of A/c 5	3214 1	4043 9	5194 2
2. Net increase in financial assets—balancing item of A/c 4	3245.8	3460 1	3832 8	6 Decrease in cash balance	472 5	272 8	1 0
3. Increase in cash balance							
4. Total	3686 6	4316 7	5195 2	7 Total	3686 6	4316 7	5195 2

Source: Ministry of Finance, Government of India *An Economic and Functional Classification of the Central Government Budget*, 1978-79.

represents the net outlay on financial investments and loans of the Central Government. If we add to this the deficit in Account 3 (item 7), we get the total requirements of finance which is met out of (*i*) net domestic borrowings, (*ii*) net foreign borrowings, and (*iii*) deficit financing.

It may be noted that Government concerns (item 1.1) are those non-departmental commercial undertakings of the Government in which the Central Government owns more than 50% of share capital. Acquisition of shares through the nationalisation of banks, general insurance etc., is also treated as investment. Item 4 covers susbscriptions to IBRD, IDA and ADB. Item 7 includes loan repayments by public undertakings. Note that short-term agricultural loans in respect of States and foreign technical credit in respect of others are supposed to be repaid in the course of the same year and therefore appear as items of receipts as well as of expenditure.

Account 5

This Account represents the borrowing Account of the Central Government and is concerned with the provision of finance for meeting the deficits arising from Account 3 and Account 4. Accordingly, the incomings give details of market borrowings, gross borrowing from abroad, and similar other sources, like borrowings from the Reserve Bank of India etc. Since borrowings from the Reserve Bank of India are quite important in magnitude, it would be preferable to look a little more into their details. For example, net sales of treasury bills are after the adjustment for funding operations (conversion of treasury bills, which have a maturity of 13 weeks at the time of issue, into 'long-dated' securities which have a maturity of more than a year at the time of issue). Net sales of special treasury bills (item 12.1) denotes the result of transactions in the issue of non-negotiable non-interest bearing securities from subscriptions to IMF, IBRD, IDA and ADB and their encashment.

Account 6

This is the reconciliation account. It sums up the net position with regard to Accounts 3, 4 and 5 and shows the effect of all Central Government transactions on its cash position. If we take the net variation in cash balance and read it with net sales of 'other treasury bills' (item 12.2 of Account 5), we get a conventional measure of the Central Government's budgetary deficit. We may note that, in India, a part of long-dated loans of the Central Government is generally taken up by the Reserve Bank of India. However, the conventional

definition of budgetary deficit in India covers only the reduction in cash balances and the net sale of treasury bills other than the special treasury bills. Obviously, for certain economic purposes, the remaining borrowings from the Reserve Bank of India should also be included in the calculation of budgetary deficit.

Let us now take up *functional classification* of budgetary accounts. Here, the term function means a 'purpose' such as defence, education, health etc. This classification is to supplement the type of functional classification which the budget in its original form carries. Further the functional classification *covers only the expenditure and not the receipts*. From the economic classification tables this total expenditure is obtained by adding up the current expenditure in Account 1, capital expenditure in Account 3 and financial assets and loans and advances in Account 4. The current expenditure of departmental commercial undertakings cannot be related to specific functions, though their capital expenditure can be. Accordingly, from the functional classification the current expenditure of these undertakings is excluded, but the capital expenditure is included.

The UN Bureau of Economic Affairs, New York, in its "A manual for Economic and Functional Classification of Government Transactions" 1959 groups expenditure under five heads viz., General Services, Community Services, Social Services, Economic Services and Unallocable. The National Council of Applied Economic Research, in its "Economic-Functional Classification of Central and State Government Budgets—1957-58" omitted the category of Community Services and allocated the services shown in the Manual under the head to Social Services or Economic Services as the case might be. This pattern has been followed by the Government of India also. Accordingly the functional classification of its expenditure has been allocated under four heads: (*i*) General Services, (*ii*) Social Services, (*iii*) Economic Services, and (*iv*) Unallocable.

(*i*) The category of General Services covers both civil and defence expenditure meant to provide the basic administrative structure and includes the general administration, tax collection, police, currency and mint, external affairs, defence, non-plan provision against natural calamities, etc. However, the administrative expenditures connected with direction and superintendence of various social and economic activities appear under the relevant functional heads. In case more than one activity is included, the expenditure is appropriated between them as best as can be. Subscriptions to IMF, IBRD, etc., (but not to WHO and FAO) are also shown here.

(*ii*) Social Services would include basic social amenities like educa-

TABLE 13.7

ECONOMIC-CUM-FUNCTIONAL CLASSIFICATION OF GOVERNMENT OF INDIA BUDGET, 1976-77

(Rs crores)

↓ Economic / Functional →	General Services: Services other than Defence	General Services: Defence Services	Social Services: Education	Social Services: Medical and Public Health	Social Services: Other Social Services	Economic Services: Agriculture	Economic Services: Industry	Economic Services: Transport and Communications	Economic Services: Other Economic Services	Economic Services: Block Grants and Loans	Unallocable	Total
1. Consumption Expenditure	749.5	2771.1	53.0	47.7	220.6	65.7	115.2	58 0	59.1	...	..	4139.9
2. Transfer payments												
(i) interest	...	...	...	. .	...	...	...	...	...	...	1690 2	1690.2
(ii) grant												
(a) to States and Union Territories	26.4	...	39.9	214 3	104 9	99.4	16.0	15 7	19 6	475 8	733.1	1745.1
(b) to Local Authorities	2.1	...	10.6	1.7	4 1	0.3	.	7 9	...	...	...	26.7
(c) to others	1.7	...	199 3	17.0	35 2	167.7	109 3	4.4	43.5	...	...	576.1
(iii) other current transfers												
(a) subsidies	...	...	...	2.8	2.9	80.6	416.4	0.8	0.2	...	485.1	1018.8
(b) pensions	...	...	...	...	...	...	..	...	...	...	157.0	157.0
(c) others	0.3	...	6.4	0.2	16.0	...	5 5	...	0.3	...	34.0	62.7
3. Gross capital formation												
(i) gross fixed capital formation	65.8	...	7.6	9.2	73.2	46.7	198.8	1030.5	31.8	...	...	1463.6
(ii) stocks	—0.2	...	0.3	0.3	8 9	109.3	34 1	12.9	0.2	...	...	165.8
4. Capital transfers												
(i) grants for capital formation												
(a) to States and Union Territories	...	...	...	0.1	86.0	135.8	19.9	42.3	...	475.8	...	759.9
(b) to non-departmental commercial undertakings	...	...	...	...	...	2.2	83.7	13.9	...	...	...	99.8

(*c*) to Local Authorities	...	...	...	...	0.9	4.8	0.3	5.4	...	...	...	11.4
(*d*) to others	. .	...	...	...	2.2	70.8	16.6	...	...	...	...	89.6
(*ii*) other capital transfers	...	...	...	...	...	...	...	...	...	...	92.5	92.5
5. Investment in shares												
(*i*) of government companies												
(*a*) financial concerns	...	...	..	...	0.3	1.1	20.6	...	...	...	...	22.0
(*b*) others	...	...	...	...	5.5	34.0	1083.6	25.7	1.5	...	...	1150.3
(*ii*) of other concerns	...	...	...	...	0.2	24.5	4.7	...	0.9	...	...	30.3
6. Loans of capital formation												
(*i*) to States and Union Territories	...	...	...	0.1	19.3	70.8	77.0	14.6	307.0	1580.9	...	2069.7
(*ii*) to non-departmental undertakings												
(*a*) financial concerns	...	...	...	...	...	158.5	81.0	79.0	6.0	...	...	324.5
(*b*) others	...	...	...	...	...	75.5	643.5	6.8	1.5	...	...	727.5
(*iii*) to Local Authorities	...	...	...	...	20.2	...	24.3	53.7	...	...	...	98.2
(*iv*) to others	...	...	0.1	...	28.9	0.2	2.6	...	1.6	...	...	34.3
7. Other loans												
(*i*) to States and Union Territories	8.5	...	4.0	...	1.0	113.0	...	...	7.6	...	16.0	150.1
(*ii*) to non-departmental commercial undertakings	. .	...	...	...	1.6	7.7	45.9	4.5	...	...	...	59.7
(*iii*) to foreign governments	...	...	...	...	...	..	...	...	...	...	445.6	445.6
(*iv*) to Local Authorities	...	...	. .	...	...	1.7	...	...	...	...	...	1.7
(*v*) to others	17.8	...	1.1	...	24.8	0.1	5.1	...	6.0	...	...	54.9
8. Subscriptions to international financial organizations	247.5	...	...	...	...	...	...	...	...	...	...	247.5
9. Net purchase of domestic gold and silver	2.2	...	...	...	...	...	...	...	...	...	...	2.2
Total	1119.6	2771.1	322.3	293.4	656.9	1270.4	3034.1	1376.1	486.8	2532.5	3653.5	17516.7

tion, medical and public health (including family planning programmes and contributions to WHO), basic research, etc , and a combined category of labour welfare, housing and other social welfare schemes like public libraries, publicity, programmes of employment, lump sum grants for slum clearance, primary education, rural water supply, rural home sites, nutrition programme for children and the like.

(*iii*) Economic Services cover all those expenditures which directly or indirectly promote economic activity within the country and are divided into agriculture, industry, transport and communications and other economic services. Contributions to FAO are also shown here. Irrigation, animal husbandry, fisheries, forestry, cooperation and community development are included in agriculture.

(*iv*) The Unallocable category covers those items which cannot be classified under the above three heads like interest payments, pensions, food subsidies, statutory grants-in-aid to States, special loans, aid to foreign countries and the like.

And *lastly* we have the cross-classification of the Central Government expenditure by economic categories (row rise) and by functions (column wise) If we move along a row from column to column, we get the functional break up of expenditure on a particular head. And if we move along a column from one row to the other, we get the breakdown of a functional expenditure into economic categories. Such an economic-cum-functional classification is illustrated for the Central Government Budget for the year 1976-77.

Inferences

The usefulness of these accounts for the purpose of arriving at important magnitudes can be illustrated as follows.

1. The total expenditure of the Government of India may be obtained by adding the three parts (*i*), (*ii*), and (*iii*) as given below:
   (*i*) Final outlays, the figure for which is obtained by adding up
      (*a*) Government consumption expenditure, (item 1 of Account 1), and
      (*b*) Gross capital formation (vide Account 3) consisting of
         1. Gross fixed capital formation (item 1 of Account 3), and
         2. Increase in inventories (item 2 of Account 3).
   (*ii*) Transfer payments consisting of
      (*a*) current transfers (item 2 of Account 1)
      (*b*) capital transfers (item 3 of Account 3)
   (*iii*) Financial investments and loans to the rest of the economy

(Account 4).

II. To estimate the Financial Assistance for Capital Formation by the Government of India we add up the following:

(*i*) Grants and loans to States and Union Territories [item 3.1 (*a*) in Account 3 and item 2.1 in Account 4].

(*ii*) Grants and loans to non-departmental commercial undertakings and investment in shares of Government concerns [item 3.1(*b*) in Account 3 plus items 1.1 and 2.3 in Account 4].

(*iii*) Grants and loans to Local Authorities [item 3.1 (*c*) in Account 3 and item 2.2 in Account 4].

(*iv*) Grants and loans to 'others' and investment in shares of 'other concerns' [item 3.1 (*d*) in Account 3 and items 1.2 and 2.4 in Account 4].

III. To get Gross Capital Formation from Budgetary Resources, we add up

(*i*) the Gross Capital Formation by the Government of India (as seen in I), and

(*ii*) financial assistance for capital formation to the rest of the economy (as seen in II)

IV. To get Government of India Net Capital Formation, we add up

(*i*) New outlay on buildings and other construction [item 1.1 (*a*) in Account 3]

(*ii*) New outlay on machinery and equipment [item 1.2(*a*) in Account 3] and

(*iii*) Increase in inventories (item 2 in Account 3).

V. Addition of (*i*), (*ii*) and (*iii*) below would give us Gross Savings of the Government of India, and subtraction of (*iv*) from this total would give us Net Savings of the Government of India.

(*i*) Savings of Government Administration (item 5.1 in Account 3).

(*ii*) Net retained profits of departmental commercial undertakings (item 5.2 in Account 3).

(*iii*) Depreciation provision of the departmental commercial undertakings (item 5.3 in Account 3).

(*iv*) Expenditure on renewels and replacements of departmental commercial undertakings [items 1.1(*b*) and 1.2(*b*) in Account 3).

VI. Figure for Income Deficit is obtained if we subtract Net Savings by Government of India (from V above) from Net Capital Formation (IV above).

VII. For arriving at Total Requirements of Finance by the Central

Government we add up (*i*) the balancing item 7 in Account 3 and (*ii*) the balancing item 8 of Account 4. It is the total of income deficit and (after adjustment for net capital transfers) the deficit arising out of the Government's net transactions in financial assets such as investments in shares and loans.

VIII. Estimate of Income Generation is obtained by the addition of the following:

(*i*) Wages and salaries paid by the Government Administration item 1 1 in Account 1).

(*ii*) Net output of departmental commercial undertakings, consisting of

(*a*) wages and salaries (item 1 of Account 2), and wages and salaries component of repairs and maintenance operations (50% of item 4, Account 2).

(*b*) interest (item 5 of Account 2), and

(*c*) profits transferred to the current account of Government Administration (item 7 of Account 2) plus retained profits (item 8 of Account 2) plus excess of depreciation over renewals and replacements.

(*iii*) Wages and salaries component of Government outlays on construction (1/3 of item 1 1 of Account 3)

It may be remembered that economic and functional classification of the government budget is not without *limitations*. It reflects only one end of the picture The government activities, as reflected by the economic and functional classification of the budgets, have far reaching effects on the working of the economy (and it is primarily on account of these effects that we are interested in this classification. This classification is not able to tell us, by itself what the budget is *indirectly* doing for the economy These effects have to be estimated and as yet no precise techniques are available for this task. The estimates of these effects, therefore, are generally inexact. Furthermore, it is not only the budgetary magnitudes as reflected in the economic and functional classification, but various additional variables also whose relevance is beyond doubt Every government has some regulatory devices and some governments have quite a few of them—in addition to the over-all budgetary magnitudes Within the broad magnitudes, the exact composition of taxes and expenditures will have their role to play Furthermore, some of the government activities might be working at cross purposes with private economic activities For example, the social security measures taken by the government might reduce the will of the people to save and invest Similarly, the economic and functional classification of the budget is

not fully able to reflect its impact on income and wealth distribution in the economy. For greater completeness, therefore, the classification should cover both Central and State Governments together with other agencies in the public sector. And such a classification should be linked with a similar classification for the private sector of the economy as well. In other words, the ideal is to have a proper classification of the 'national budget' based upon the required statistical data and enabling us to study various aspects of the economy.

The Accounts, as they are, are quite aggregative. They are very useful to the extent they go, but they are not able to provide the necessary breakdown of various components. For example, a further breakup of capital formation, wages and salaries and the like would be useful. Take the question of estimating income generation through the budgetary magnitudes. We found that it was to be a summation of three sub-totals in which the third sub-total would be 'wages and salaries component of Government's outlay on construction'. This figure is not directly available from the Accounts. Further, while estimating these aggregate figures, some portions of this item are derived arbitrarily and added to the total. Thus, one-third of the works expenditure is treated as wages and salaries component and similarly in the case of 'repairs and maintenance' this component is taken one-half "since the required break-up is not availab'e." Lump sum provisions in the budget have been similarly broken-down into expenditure on wages and salaries and commodities and services in the ratio of 50 : 50. In the same way, a further break-up of this expenditure between defence (capital outlay on defence is treated as current expenditure), health etc., is also needed.

It must, however, be emphasised that these Accounts even as they are, are highly useful and their usefulness has been further enhanced with the introduction of functional classification. They enable us to arrive at many useful economic magnitudes of our economy and help in inferring the budgetary role therein. Similarly, functional classification is basic to an effective programme and performance budgeting.

PERFORMANCE AND PROGRAMME BUDGETING SYSTEM (PPBS)

The resources at the disposal of the government are always scarce in comparison with the various services it would like to provide to the society. Accordingly, it must try to use these resources most economically and efficiently. To this end, alternative expenditure proposals should be weighed in terms of their respective costs and benefits and

it should be ensured that the chosen programmes are subjected to the tests of actual performance against their expected results. The formulation of the budget proposals should be directly related to the extent to which they can be implemented. The success of the implementation depends upon the inherent soundness of the proposals, the efficiency, the adequacy and integrity of the government machinery and the additional relevant circumstances. Since the actual results usually do not conform to the ones planned for, a system of assessment is needed. This implies that the decision to spend a particular set of resources for a particular purpose (we may call it the project) involves *programming* or laying down the sequence of steps for executing the project along with the expenditure of resources involved at each stage. Such a programme, by its very nature, will also indicate the corresponding results that are expected. This part of budgeting is called programme budgeting. Tests have also to be devised to estimate the actual results or performance with the expected results and thereby judge the extent of efficiency or inefficiency with which the said project is executed. This aspect of budgeting is referred to as the performance budgeting. As the Hoover Commission in the USA stated, a performance budget is based upon activities, functions and projects of the government. When budgeting covers both the above mentioned aspects, it may be termed Performance and Programme Budgeting (PPB) or Performance and Programme Budgeting System (PPBS).

PPBS is the culmination of efforts aimed at improving the formulation and execution of expenditure policy of the government at the executive (not legislative) level. The traditional approach in public expenditure was to ensure the accountability of the executive to the legislature and accordingly rules were laid down which the executive had to abide by. In due course, however, the inadequacy of this approach was realized and efforts were made to work out rules of managerial efficiency and flexibility in the process. The concept of PPB is the last in the series of such improvements in which both *the formulation and the execution* of expenditure policy are sought to be improved.

The rationale of PPBS is based upon some fundamental propositions. *Firstly*, it recognizes the fundamental nature of our economic problems, i.e., that they arise out of the basic scarcity of resources as compared with the requirements of the society. These various ends have competing claims upon the resources of the society and only those should be chosen which have the least cost-benefit ratios.

Secondly, **it is not only the choice of particular projects which is**

relevant. There is an equally strong case for efficient execution of the chosen projects. For this, therefore, the criteria of efficiency and the steps for achieving the same have to be devised. There must also be ways of judging the extent of shortfalls or over-achievements, if any.

Thirdly, PPBS recognizes the fact that in the conventional budgetary techniques and policies, there are no automatic regulators which would indicate to the executive and the legislature as to when the usefulness of a particular project has ceased, or when its usefulness has undergone a substantial change. For this, there must be a method of furnishing the feedback on the efficiency of various decisions and their outcome. Such a system of feedback is bound to be imperfect to begin with; but we should hope that with the experience and over time, it would improve. And in any case, it is better to have an imperfect system than to do without it.

Fourthly, without an appropriate PPBS, a kind of haphazardness creeps into government decisions. Effective decision-making is generally divided between several government agencies while particular projects and their results should be viewed in their entirety and not in parts. This implies that in most cases the decisions of more than one agencies would have to be coordinated and the effects assessed at different stages and in different spheres. Ad hoc solutions are sometimes extremely useful, but ad hocism cannot be advocated as a policy. It is a destructive policy tool especially when we bring in the fact that the present is so closely linked with the future. "The fundamental premises of programme budgeting are that policy and budgets are inseparable, and that the relationship between the structure and implementation of budgets and the determination and achievement of policy objectives should be made explicit. Programme budgeting is then a set of procedures designed to improve the basis for policy decisions and to secure a more effective and efficient allocation of scarce resources in the public sector, the output of which does not generally command a market price."[8]

Fifthly, the problem becomes further complicated on account of the fact that government budgeting is usually on an annual basis while a large number of projects and programmes extend over much longer periods. There has to be, therefore, an effective assessment of and coordination between budgetary provisions and policies over a span of time. PPB "puts heavy stress on *forward programming* "

It may be emphasised that PPBS is not a mechanical thing. It does

[8]James Cutt, *A Planning, Programming, and Budgetary Manual—Resource Allocation in Public Sector Economics*, Praeger Publications, 1974, p. 2.

not replace the basic reliance upon sound human judgement. Its main task is to help such a judgement in arriving at better decisions. PPBS does not ignore the human factors, either on the cost or on the benefit side of a project. It takes into account even those human factors which cannot be quantified. To say that the analysis is systematic does not imply that it has to be quantitative. The objective is to improve the process of decision-making by the authorities such that the irrelevant issues are eliminated and all the relevant ones are incorporated. Such an analysis demands that the assumptions underlying decisions should be specifically spelt out and the programme modified (if need be) whenever any significant change takes p'ace in the underlying assumptions. This system need not cover every expenditure decision; but all the major government activities ought to be covered. Different alternatives and possible combinations of these alternatives have to be worked out for the optimum utilization of the resources. As an example, we may think of the alternative sources of energy which our country should think of tapping—coal, hydroelectricity, petroleum, geothermal sources, wind, solar energy, and the like. Obviously, PPBS has a vast scope and different major areas of application would demand different analytical techniques and criteria. The extent of success is also bound to be limited in the initial stages. But the corresponding usefulness of this approach warrants that a beginning be made with important areas [9]

Technically, the performance and programme budgets are similar but not identical.[10] Programme budgeting consists of three stages. The first one consists of defining the goals or objectives of various fiscal measures and policies. The emphasis here is on the output or results side of various programmes. This stage, therefore, involves a series of programmes and schemes aiming at achieving different objectives. The second stage is analytical in nature. It adopts a cost-benefit approach and therefore finds out alternative ways of achieving the said goals together with costs and benefits. Of the various alternatives available the most economical (in relation to the expected results) ones are expected to be chosen. The third stage may be called projective, that is, the current programmes and policies are related to the future benefits, problems, costs and other developments. At the end of the period, however, the actual performance of the chosen programmes must also be evaluated. This assessment is

[9]Charles L. Schultz in James W. Davis, Jr. (ed.), *Politics, Programmes and Budgets*, Prentice Hall, 1969, p. 189.

[10]Cf. Jess Burkhead, *Government Budgeting*, New York, 1956, p. 139.

referred to as the "performance budgeting." The programming and performance budgets are interlinked, and one has no useful meaning without the other. Programme budgets, by their very nature, are forward looking. They are related to what is planned or programmed to be achieved in the coming periods. Programme budgeting is "essentially a long-term "rolling planning system" under which budget is an allocative process between competing claims, and the budget itself a statement of policy for the appropriate planning period." Accordingly, a proper implementation of programme budgeting requires the development of a multi-year financial plan and a corresponding multi-year programme plan. In the financial plan the estimated inputs or costs are specified and combined with the corresponding programmes (or outputs) or benefits. A performance budget, on the other hand, is to reflect a record of accomplishments and failures. PPB is an important aid to the governmental decisions and an efficient PPB will be of great help to the authorities. Not only will such a system enable the authorities to improve their decision-making process, it will also help them to achieve better results at lower costs.[11]

It would be noted that a number of government services are difficult to measure in terms of their performance and therefore numerous conceptual and other problems come up. For example, more than one programmes may be aiming at the same objective or one programme may be aiming at more than one objective. Similarly, a number of programmes with intangible results would be there such as those trying to improve the quality of education, health, hygiene, and so on. Schultz tell us that from the political point of view less flexibility is available in those areas of economic activity where it is easier to apply analytical techniques. On the other hand, where there is less of political rigidity, the data usually do not permit a good, precise and comprehensive analytical approach.[12] "PPBS is by no means a cut and dried matter. . .In particular, there is a room for controversy about output classification . . . and as for performance checking, this is more easily talked about than done."[13] PPBS is heavily dependent upon an efficient system of budget accounts which should permit the requisite analytical dissection. Institutional and other arrangements

[11]James Cutt, *op. cit.*, p. 3.

[12]Charles L. Schultz, *The Politics and Economics of Public Spending*, The Brookings Institution, 1968, pp. 88-89.

[13]A. R. Prest, *Public Finance in Underdeveloped Countries*, Vikas Publishing House,1973, p. 155.

in a country will matter a lot in the precise techniques of PPBS that may be adopted. Above all, it is obvious that the efficiency of any such analytical system will depend upon the efficiency of the analyst also. As yet the skills required for this purpose are in their infancy and that is why even in developed countries PPBS is applied only in a limited way.

For a proper PPBS, an efficient functional classification of the budget and the accounting system is of a great help. Functional classification of the budget itself enables us to obtain information on the aggregates of major functions or purposes of the government. If this functional accounting approach is extended to the level of departments and other organizational units, the task of PPB gets greatly facilitated. An efficient PPB cannot be implemented with aggregative categories at the national level such as agriculture, industry, public health etc. Such a compilation of data under major heads of accounts is, of course, very useful in providing information about the broad purposes or functions of government. But it fails to identify the specific programmes of government of their relative costs. For that, a detailed analysis and breakdown of governmental functions in terms of specific programmes, activities and projects is needed. Each ministry, department, or section can be used as the organizational level at which the required choice between various programmes is to be made. Such a choice should take into account the relevant information of relative costs and benefits as revealed with the aid of the detailed functional accounting. This further helps in judging the performance of various projects in an effective manner. "At a point where functional classification is extended to an analysis of the over-all and subsidiary activities and programmes of each ministry or department and suitable yardsticks of performance for these programmes have been devised, the concept of functional classification becomes almost synonymous with that of performance budgeting."[14] In this way, "One of the prime requisites of the introduction of performance budgeting is a complete integration of budgetary and accounting classification and the progress in its application will hinge substantially on the degree to which a parallel and well coordinated accounting structure can be developed to provide timely and current data for the appraisal of performance and various programmes and activities."[15]

[14]Administrative Reforms Commission, *Report of the Study Team—Accounts and Audit*, September 1967, para 5.6.

[15]*Ibid.*, para 5.8.

Though in an accounting system, all the components of a programme should be at one place and under one control, in practice it is often not possible to do so. Questions of administrative considerations, technical efficiency and many others come in. And in the final analysis, in India, it is not essential to shake up the existing organizational and accounting system. Accounting system should be only supplemented and not replaced by a new one. In evolving an effective and efficient PPBS, we should start with the analysis of important programmes, projects and activities and the corresponding accounting system most suitable to this end should be worked out. This accounting system should be so designed as to enable us to devise suitable yardsticks for measuring the actual performance and for improving the same. Accordingly, the Study Team on Budgetary Reforms of the Administrative Reforms Commission recommendeda phased introduction of the PPBS in India with priority assigned to those departments and organisations which handle programmes and involve large expenditure. This was accordingly done.

In India, all the ministries and departments were preparing performance budgets by the year 1975-76. These performance budgets present the main projects, programmes and activities in the light of the specific objectives and an assessment of the previous year's budgets and achievements. As yet these budgetary techniques are in their infancy. There is also a need for all the ministries and departments to evolve rationale and objective standards of performance in each case. Also, it is essential that the relevant information be made available to the units dealing with the performance budgeting. It is hoped that in due course, we shall be able to achieve respectable standards in performance budgeting. Once this is done, the performance budgets would become an effective tool in monitoring of plan schemes and effective utilization of funds provided for them. Without the performance budgets the accountability of effective utilization of funds is reduced to only non-violation of audit rules.

14 BALANCED BUDGET AND FISCAL POLICY

BALANCED BUDGET

The term balance budget has been used in different connotations, and we find that with them various economic and policy interpretations attached. Thus, we may look at the budget from the accounting angle, or in terms of an economic meaning of different items included in the budget or the receipts and expenditure sides and their impact on the flow of funds and other variables. The budget might also be viewed in its totality or in parts such as its revenue account and capital account portions. In each case, however the period over which the deficit or surplus in a budget is to be estimated is also relevant.

The traditional approach in economic literature was to look at the budget from the accounting point of view and justify the same in terms of different arguments many of which have been refuted later. According to the traditional view, a budget would be balanced if the revenue of the government meets its expenditure over the period under consideration. This stand, as would be noted, compares the total revenue of the government with its total expenditure. However, on the revenue side, borrowings (both long-term and short-term, internal and external) are not included. But it will be noted that to be reasonable, even in this accounting sense, reinterpretation of some receipts and expenditure would be needed. Thus, repayment of the loans should not be counted towards the current year's deficit, though interest payments on those loans should be so counted. To put it differently, we should look at the *net change* in the public debt rather than at the new borrowings. Similarly, the authorities might meet apart of expenditure through a reduction in their cash balances or by sale of some public assets. To the extent that happens, it should be counted as a part of the deficit just as an addition to the cash balances or public assets should be counted as a part of the surplus budget.

In economic sense, different interpretations can be ascribed to the terms surplus and deficit budgets. In India, the official approach is to distinguish between "market borrowings" and "borrowings from the Reserve Bank of India" to arrive at the estimate of a

budgetary deficit. The "market borrowings" are the long-term borrowings—borrowings by issuing loans having a maturity of more than one year at the time of issue. Market borrowings are included in the revenue receipts and therefore do not form a part of the budgetary deficit.

The logic behind this approach is that such market borrowings only divert the investible funds from the market economy into the hands of the authorities and therefore their use by the governments does not lead to any net addition to the total flow of purchasing power and demand in the economy. Such borrowings, therefore, do not add to inflationary pressures. Budgetary deficit, therefore, is taken only to indicate that public expenditure which is financed by (*i*) drawing down of the cash balances, and (*ii*) by short-term borrowings from the banking sector—more specifically by means of Treasury Bills. The Treasury Bills are mostly purchased by the Reserve Bank of India though some of them are taken up by the State Bank of India, the State Governments and some other approved bodies also.

The Government of India can also borrow from the Reserve Bank of India in the form of 'ways and means advances' but this facility has not been used by the Government of India since 1943. The use of Treasury Deposit Receipts (they can have different maturities ranging from one week to one year) for short-term borrowings has been quite limited and since the mid 1950s their use has been discarded. The State Governments can borrow within the prescribed limits from the Reserve Bank of India and when they do, such borrowings also become a part of the over all budgetary deficit for the country in terms of their economic effects.

In reality, however, we find that the Indian official view is defective.

Firstly, it is a fact that the part of the "market borrowings" are taken up by the Reserve Bank of India itself. The effect of the loans taken up by the Reserve Bank of India is the same whether they are short-term or long-term ones since in both cases there is a net addition to total flow of currency and demand in the country. The Reserve Bank, having obtained the government securities, credits the corresponding amounts to the Government in its books. When the Government spends out of those accounts, the Reserve Bank issues currency to the people to whom the Government wants to make the payments. If the Reserve Bank wants to keep the currency supply under check, it has to do so through other means.

Secondly, it is wrong to suggest that even the loans which are taken up by the market are neutral in their effects. There may be an overall shift in the employment of resources from consumption into

capital goods sector causing an addition to the inflationary pressures. Or the Government may be utilizing the borrowed funds for financing its welfare programmes, etc. In other words, apart from the way the loans are raised, their effects will also depend upon the way they are spent.

As stated above, the question of choosing an appropriate period over which the budget is to balance is an important one. Any period so chosen (say a year), would be arbitrary. It was for this reason that Jacob Viner ridiculed the choice of one year irrespective of the circumstances attending upon the choice.[1] The American economists advocated that the budget should balance over a trade cycle. But as Dalton points out, in some countries (such as those belonging to the socialist block) there would be no trade cycles. In some other countries, trade cycles would occur only in a weak form. And in any case, trade cycles do not exhibit any fixed periodicity with reference to which the budgetary balance could be programmed. One may even add that the very policy of balancing the budgets would weaken the intensity of the trade cycles.

Arguments for Balanced Budgets

(1) The traditional view was in conformity with the ideals of "soundness" of private budgets. A private economic unit should try to avoid deficits, and if it has to incur a deficit at any time, it must try to wipe it out as soon as possible. This argument was extended to the field of public finance also. This argument had its origin in the tendency of the governments resorting to wasteful and unnecessary expenditure. It was felt that a government must exercise a financial discipline upon itself and must keep its expenditure within the available revenue. This was therefore considered an effective check upon any extravagance of the authorities

(2) It is also argued that a deficit budget adds to the currency and money supply in the country and thereby strengthens the inflationary pressures.

(3) It is argued that any tax effort by the authorities meets with some resistance by the tax-payers. This acts as a check on undue and wasteful expenditure proposals of the authorities. On the other hand, the government will find it much easier to extend its expenditure if it is to be financed through a deficit. People would be willing to lend to the government if given a high enough rate of return on government

[1]Jacob Viner, *Inflation as a Possible Remedy for the Depression*, University of Georgia, May 1933.

loans. And in the case of financing the deficit through resorting to the printing press, there remains no check but the one self-imposed by the authorities. Once, therefore, the authorities feel free to have a deficit budget, they are likely to be less inhibited in future also. Moreover, since deficit budgets create inflationary pressures, the authorities would find their expenditure mounting up. This phenomenon itself will add to the temptation to have deficit budgets in future also.

(4) One argument in favour of deficit budgets is that they help the economy in fighting a depression. However, the theory of 'balanced budget multiplier' shows that with appropriate qualifying conditions, even a balanced budget can raise the level of economic activity and income provided the size of the budget is increased.[2] In other words, to cure a depression (or an inflationary pressure) just an appropriate change in the size of the budget would do.

Arguments against Balanced Budgets

(1) The aim of the budgetary policy of the government should not be to go in for a balanced budget for its own sake. Public budgets do not stand on the same footing as the private ones, either in terms of objectives or in terms of design. The objectives of a public budget must include the one to avoid any harmful effects on the economy. And if possible the budget should be used to effectively help the economy. The advocates of the balanced budgets assume that the government sector is superimposed upon the economy and is something foreign to it. This stand is obviously wrong and does not need refutation. Furthermore, it is implicitly or explicitly suggested by the advocates of balanced budgetary policy that the public budgets must be *neutral* in their impact on the economy. It is also suggested that the market mechanism is able to bring about the best possible allocation of productive resources, employment and the like and the public budgets should not distort the market results.

These suggestions have obvious flaws.

Firstly, if the government is a part of the economy (as it actually is), its budget cannot be neutral in its impact. And the impact of the budget should be more, the larger its contribution to the flows of funds in the economy. As we have seen in an earlier chapter there is a strong tendency for the public expenditure to increase as a proportion of the total expenditure in the economy. And therefore, over time, the public budgets are becoming less and less neutral. We may

[2]We shall look into the details of 'balanced budget multiplier' later in this chapter.

note, further, that public budgets are composed of two sets of receipts and expenditure. One set is sufficiently rigid and the other is variable. For example, on the expenditure side, various contractual payments have to be made. There are similarly many contractual receipts. The budgetary policy can be designed only with reference to those items which are variable.

Secondly, even if it were possible to have a neutral budget, we can question the desirability of having one. It is now well recognized that the market forces are not capable of bringing about the optimum results in the economy and one can mention trade cycles, inequalities of income and wealth distribution and so on as examples in this connection. The need for an active budgetary policy designed to remove these ills cannot be denied. And in underdeveloped countries, there is a strong case for the budgetary policy which accelerates the economic growth.

(2) Now let us consider the argument that a deficit budget adds to the inflationary pressures. This argument, unless put forward in a proper context, tends to misguide us.

Firstly, the impact of a deficit budget does not depend upon only the presence or absence of the deficit. The more relevant factors are the *size* of the deficit (in relation to the overall size of the national income) and the *persistence* of it. One major deficit might be more damaging than many minor ones. In a developing economy, for example, some deficit budgeting would be needed to provide a financial counterpart to the increasing monetization of the economy.

Secondly, there can be circumstances when a budgetary deficit would be only reflationary in character and would be only helping the economy in recovering from a depression. During a period of depression, if the economy has a reasonable flexibility, a budgetary deficit would boost up production and employment.

Thirdly, the change in the purchasing power of money depends upon the demand for and supply of goods and services by *both* the public and private sectors. A surplus or a deficit budget may be partly or fully counter-balanced by the opposite behaviour of the private sector.

(3) Keynes[3] maintains that the budgetary measures intended to balance the budget themselves lead to subsequent budgetary deficits and the measures intended to create deficit would help them, subsequently, to balance. Keynesian argument can be put as follows.

During a depression, there is an all-round downward pressure on

[3]J. M. Keynes, *Means to Prosperity*, 1933.

revenues. Thus because of a fall in the volume of production and prices, indirect taxes would fall. Because of a general reduction in the national income, and because of the progressiveness of taxation, direct taxes would also fall. On the other hand, public expenditure would fall mainly due to the reduced cost of government purchases while there would be a tendency for some expenditures (such as to help the unemployed) to increase. And when the government tries to balance its budget by raising more revenue through higher taxes there is further disincentive to investment and consumption and a further reduction in production, employment and national income. Thus, the taxation measures which the government takes to balance its budget themselves push the public budgets to further deficits. Just the opposite happens in the case of booms. There, with increasing employment, national income, prices and output, the public revenue gets augmented while the public expenditure lags behind. If now the government reduces the taxes to reduce the budget surplus, a further impetus to investment and employment is imparted leading to another round of surplus Arthur Smithies adds by saying that an attempt to balance the budget annually will worsen the economic fluctuations in the country.[4] During a depression, in an attempt to balance the budget, the government reduces its expenditure and increases taxes, thus, helping the depression. During a boom, when it should aim-at restricting over all expenditure, it encourages the expenditure by reducing taxation.

(4) The argument that a deficit budget today restricts the budgetary flexibility of tomorrow, is not exactly true. It must be argued that a policy of avoiding today's deficit at any cost is itself a major restriction on the budgetary policy. Furthermore, there are some forces which add to future flexibility. A large debt (which would result from a number of deficits over time) certainly adds to the government's armoury in the form of debt management tools and provides a means for an effective monetary policy also. And the overall fiscal flexibility is greater when the government can add to or reduce the debt volume.

(5) The argument that a balanced budget is a means of financial discipline and efficient management of the financial affairs of the government is not guaranteed. A balanced budget itself does not necessarily imply an absence of wasteful expenditure. It is quite

[4]Arthur Smithies, "The Balanced Budget," *American Economic Review*, May 1960, reprinted in William D. Grampp and Emanuel T. Weiler (ed.), *Economic Policy*, p. 65.

possible, as Arthur Smithies says, that an effort to have a balanced budget during a given period of time may rather lead to a wasteful expenditure.[5] A project, for example, having been started, might be left in between on the pretext of not exceeding a certain limit of expenditure (within the budgetary period) but such a delay would raise the cost of the project. Again, it is also possible that the total public expenditure remains within the revenue available to the authorities but there is a great deal of inefficiency. And furthermore, under the pretext of financial discipline some long-term developmental scheme may not be taken up at all.

(6) Any predetermined rule like the one stating that the budget ought to be balanced, will restrict the freedom of action on the part of the authorities, and thus restrict the possible use of fiscal policy. This will be more so when we realize that the fiscal policy is one of the many economic instruments which the authorities may have to use for achieving a diverse set of objectives. Tying down the fiscal policy in any particular manner only makes it less effective, and it may also bring it into conflict with other policy tools.

THE BALANCED BUDGET MULTIPLIER

It is argued that even a balanced budget does not guarantee that the net effect on income and employment in the economy will be zero (apart from the allocative effects which the budget might cause). The first formulations of this theory which developed in the wake of Keynesian analysis, maintained that any increase in government expenditure even though fully matched by taxation, would lead to an equivalent increase in national income.[6] This reasoning was based upon the assumptions that the taxed amount, if left in the hands of the public, would be partly spent and partly saved on account of marginal propensity to consume being less than one, while the government would be spending all the tax collections. Thus, for example, if the government collects a tax revenue of Rs 100 from the public, then the net reduction in the consumption by the tax-payers would be less than Rs 100. If we assume that the marginal propensity to consume of the tax-payers is 0.75, then the reduction in private

[5] Arthur Smithies, *op. cit.*

[6] See, for example, G. K. Shaw, *Fiscal Policy*, Macmillan Studies in Economics, 1972; T. Haavelmo, "Multiplier Effects of a Balanced Budget," *Econometrica*, Oct. 1945; H. C. Wallich, "Income Generating Effects of a Balanced Budget," *Quarterly Journal of Economics*, Nov. 1944.

consumption would be only Rs 75, since that is the amount which would have been consumed out of this taxed amount. The government, on the other hand, would spend all the Rs 100, and thus would cause an initial addition to the total expenditure of Rs 25. Furthermore, given that MPC is equal to 0.75, multiplier is equal to 4 and so the initial extra expenditure of Rs 25 will lead to an additional income generation of Rs $(25 \times 4) =$ Rs 100. In this way, an increase in the size of the government budget leads to an equivalent increase in the national income, even though the additional public expenditure has been financed by additional taxation.

The early formulations of a balanced budget multiplier put its value at unity, meaning thereby that a change in national income would be exactly equal to the change in the government budget irrespective of the value of the marginal propensity to consume. The conclusion follows when we note that the net increase in expenditure (on account of the government collecting a tax and spending it (is determined by the MPC of the public and it is this very MPC which determines the value of the multiplier also. The net initial addition to the expenditure per rupees N of taxes is given by N (1—MPC) while the value of the multiplier is 1(1—MPC). Therefore, the addition to total national income is given by $[N(1-\text{MPC}][1\,(1-\text{MPC})]=N$. Thus, an increase in the size of the public budget by an amount of Rs N leads to an equivalent increase in national income, through the budget remains fully balanced.

It would be noticed that the balanced budget multiplier need not always be unity. This is a special case only. For example, if the government expenditure is in terms of transfer payments, so that the funds get shifted from one section of the people to the other, the net effect will depend upon the relative MPC of the two sections of the people. If, for example, both the recipients of government money and the tax-payers have the same MPC, the budget multiplier will be zero. This conclusion, however, is subject to two qualifications.

Firstly, it is very likely that the MPC of the tax-payers will be lower than that of the money recipients.

Secondly, a part of the tax collection would be used up on the tax collection and disbursements which will be in the nature of government expenditure. Therefore, it is most likely that even in the case of transfer payments, there will be a positive budget multiplier.

The above analysis has run in terms of consumption expenditure only. If we allow the possibilities that the taxes might cut into private investment, or that the government expenditure might induce private investment through increased demand for output, value of the multi-

plier will accordingly change. If, for example, there is an acceleration type effect on private investment, the multiplier may well exceed unity. On the other hand, if the government taxes cut into private investment, the multiplier may be less than unity.

Let us now allow the presence of foreign trade also. The propensity to import reduces the value of the multiplier. Therefore, the net multiplier effect of the budget will depend, amongst other things, on the marginal propensity to import "In particular, it is perfectly possible for the total multiplier to be negative should the importing propensity of the public sector outweigh that of the private. This latter possibility may be especially applicable in the case of a less advanced economy where private-sector imports are usually restricted whilst government development expenditures often include substantial foreign inputs.[7]

It may be remembered that the balanced budget multiplier, as analyzed above, runs in comparative-statics terms. The expansionary process in the economy generated by a balanced increase in the budget size is assumed to have worked itself out; and this expansionary effect is measured in terms of addition to the national income during the process. Such an analysis is in line with conventional multiplier analysis, but ignores many realities. For any practical application, the principle of budget multiplier has to be considered in greater details. The process, we see, is a time-consuming one and therefore the authorities have to think of the relevant intermediate positions for selecting proper policy steps. There may be a need to initiate additional multiplier processes of different magnitudes in a certain overlapping sequence. Moreover, this analysis implicitly assumes a developed economy in which an expansion of monetary demand is coupled by a corresponding expansion in real output and employment. For this assumption to hold, the economy has to have a highly competitive market mechanism. This may not be the case even in a developed economy. Presence of various monopolistic forces, organized militant trade unions and other market imperfections jeopardize the translation of the budget multiplier into an output and employment multiplier. On account of various rigidities the net result may be quite different from the theoretically expected one. In the case of an underdeveloped country, the implicit assumptions upon which this theoretical analysis is based, are least likely to be satisfied. Such a country is generally hindered by stronger institutional and economic rigidities.

[7]G. K. Shaw, *op. cit.*, p. 36.

The analysis of the balanced budget multiplier runs in terms of aggregates—tax receipts and public expenditure. Basically, however, the working of the budget multiplier would equally depend upon the composition, rates and coverage of these receipts and disbursements. This qualification is as much relevant for a developed market economy as for an underdeveloped one. For example, a particular tax revenue may be collected in one of the several alternative ways or a combination thereof, such as commodity taxation, income taxation, wealth taxation and the like. Each alternative is expected to have a different incidence pattern and a corresponding effect on saving, investment, production, employment, etc. No doubt, a given amount of tax collection will cut into the aggregate disposable income of the community by a given amount; but the net response of the economy to such a reduction in terms of various economic decisions pertaining to saving, investment etc., will depend upon the pertinent details of the collected tax revenue. Similarly, to say that any government disbursement will necessarily be as expansionary as any other is unrealistic. Public expenditure may be directed towards demand-creating channels or it may first be utilized for creation of productive potential in the economy. Each pattern of public expenditure would lead to a different result. And lastly, we must not forget, that along with budgetary activities the authorities always exercise a number of additional regulatory and monetary measures. The analysis of budget-multiplier can have, therefore, at the most a partial validity.

One important conclusion here is that even a balanced budget is not expected to be neutral in terms of its effect upon income and employment. The money income is most likely to shift in the same direction as the shift in government budget and therefore a change in the budget size becomes a policy tool in the hands of the authorities. However, this total cannot be used blindly. The exact value of the multiplier will depend upon the values of MPC and other relevant factors. Furthermore, it is not necessary that an increase in money income of the country will necessarily lead to a corresponding increase in real income also. Beyond full employment, real income and employment will not increase. Even otherwise, we often encounter a number of rigidities and specificities in the economy and so the increase in real income is not proportionate to the increase in money income.

FISCAL POLICY

It is by now clear that not only public budgets are not likely to be

neutral, they can also be used as a potent tool in different spheres of economic policy. Budgetary or fiscal policy would obviously consist of the steps and measures which the government might take both on the revenue and on expenditure sides. The field of fiscal policy is not very clearly demarcated from those of monetary policy and debt management. The main reason is that all these policy instruments deal with overlapping aspects of the economy. It is quite often maintained that fiscal policy should mean that policy which concerns itself "with aggregate effects of government expenditures and taxation on income, production and employment."[8] According to this delimitation, the micro-level effects of various taxation and expenditure measures need not be considered a part of fiscal policy proper. Mrs Hicks says that "Fiscal policy is concerned with the manner in which all the different elements of public finance, while still primarily concerned with carrying out their on duties (as the first duty of a tax is to raise revenue), may collectively be geared to forward the aims of economic policy."[9] The crux of a good and effective fiscal policy is that all the necessary ingredients like expenditures, loans, transfers, tax revenues, income from property, debt management, and the like are kept in a proper balance so as to achieve the best possible results in terms of the desired economic objectives. Discussion of individual taxation and expenditure measures is generally left out of the field of fiscal policy. But this is done only for simplicity of analysis. A practical fiscal policy is meaningless unless we are able to fill in the necessary details by working out the individual taxes and expenditure programmes. It may be noted that the detailed analysis of the effects of various components (taxation, public expenditure and public debt) of fiscal policy has already been undertaken in earlier chapters and the student is referred to look them up for necessary details.

The role of fiscal policy in regulating the economy and protecting it from the ills of the market mechanism were recognised only slowly. Official thinking (and to a great extent even the academic thinking) was wedded to that of the traditional ideals of a "sound" budgetary policy of avoiding deficits. Such a policy, amongst other things, was causing two problems. One was, as Keynes pointed out, the fact that an attempt to balance the budget would push it to an imbalance, and vice versa. The second was that through the process of balanced budget multiplier, the budget was adding to the severity of cyclical fluc-

[8]A.E.A., *Readings in Fiscal Policy*, George Allen and Unwin, 1955, p. v.

[9]U.K. Hicks, *Public Finance*, Cambridge Economic Handbooks, 3rd edn., 1968, p. 274.

tuations. It was with great difficulty that the appropriateness and usefulness of the fiscal policy in combating the ills of the economy were recognized, especially during the Great Depression of 1930s. It was conceded that the government had a primary responsibility of helping the economy towards stabilization. With the development of growth economics, it was discovered that long-run stability was itself a factor contributing to the economic growth of a country. With the advent of planning and the intense desire to bring about a rapid capital accumulation and economic growth, fiscal policy has assumed a great importance in underdeveloped countries also. In developed countries, the objectives of fiscal policy are weighed in favour of long-run stability. In underdeveloped countries, it is directed not only to stability, but also towards, promoting the growth of savings, investment and the reduction in income and wealth inequalities. However, when it comes to actual components of fiscal policy, the task is far more intricate in underdeveloped countries because here the economies are full of rigidities, shortages and other obstacles. More specifically, one important objective of fiscal policy would be to break the vicious circle of poverty and to usher in a rapid development of both agriculture and industry. To put it differently, the objective-mix and the priority-rating can differ in different countries. It is also possible that at times some immediate economic problems assume the highest priority such as that of controlling inflation, reducing unemployment, or of checking balance of payments deficit. Furthermore, it is not necessary that different objectives would always be in harmony (for example, objectives of growth and distribution in many cases come into conflict in an underdeveloped country) and a proper balancing has to be tried in that case.

Fiscal Policy and Stability

We may begin by noting that the problem of stability refers to the recurring phases of upward and downward cumulative movement in income, employment, output and prices etc., in an economy. In a developed market economy, this instability appears in the form of trade cycles. In an underdeveloped country, instability is mainly caused by importation of inflationary and deflationary pressures from abroad through foreign trade and changes in balance of payments. The role of fiscal policy in promoting economic stability was recognized very slowly, and not sufficiently till the Great Depression of 1930s. Actually, as Keynes pointed out,[10] the orthodox "sound"

[10]J. M. Keynes, *op cit.*

budgetary policy of avoiding deficits itself contributed towards greater instability and made the task of keeping the budgets balanced all the more difficult. This in fact generated a "perverse" policy on the part of the authorities, pushing the expenditure and demand in the economy down during a period of depression and pushing them up during a boom.

The development of the concepts of "multiplier" and "accelerator" and the relationship between the macro-variables like investment, income, consumption, and savings enabled the economists to visualize more clearly the mechanics of trade cycles and the role which the fiscal policy could play in a developing economy. This gave rise to the principles of compensatory finance and functional finance. It was realized that through fiscal policy the government could, to a great extent, neutralize the destabilizing movements in the economy. The general theoretical framework was that a depression is caused by a deficiency of effective demand. Fiscal policy should remedy it by increasing public expenditure and by encouraging private expenditure. Similarly, during a boom period the need is to control the demand which again can be partly done through curtailing public expenditure and partly through curbing the private expenditure. Keynes put the whole remedial scheme in terms of providing appropriate changes in total effective demand which should be increased during a depression and decreased during a boom. To this end, steps should be devised to bring about necessary changes in expenditure in both public and private sectors.

To encourage demand during depression, the authorities should step up their own expenditure and encourage that in the private sector. Public expenditure may be increased through incurring public investment directly, or enhancing consumption expenditure of the government. Similarly, subsidies (with or without tax concessions) can be used to encourage private consumption and investment. The principle of balanced budget multiplier tells us that even if increased public expenditure is financed through an equivalent taxation, the budget has an expansionary effect. But this possibility was not recognized in the early stages when the theory of compensatory finance was developed. Now, of course, it has been found that the principle of balanced budget multiplier in itself is subject to some qualifications. If, of course, these qualifications are satisfied, there will be a net increase in aggregate effactive demand through an increase in public expenditure even if it is financed through taxation. But it is obvious that a more effective method would be financing the increased public expenditure through *deficit financing*. Such a deficit might

be met either by resorting to printing press or through market borrowings. In the former case, it is expected that there will be a net addition to the total expenditure in the economy. In the latter case also, the aggregate expenditure is most likely to increase because during depression the investment opportunities in the market are not much. However, the government's expenditure policy would be more effective when the extra purchasing power goes into the hands of those people who have a high marginal propensity to consume. Various *social security measures like unemployment relief, old-age pensions.* and so on would be, therefore, very helpful in raising the total demand in the market. Productive activity would pick up faster and the existing unutilized capacity would be used if the government expenditure is mainly of consumption and welfare type without any aim at increasing additional productive capacity. Through the multiplier process, the economy would then be able to recover from the depression.

Taxation is considered an effective tool in encouraging expenditure in the private sector. Ordinarily, a general reduction in tax rates or abolition of various taxes is recommended. This would push up profits and reduce prices through a reduction in the cost of supply. Lower prices are expected to increase demand, production and employment, which in turn would bring in further increase in demand, and so on. A similar action can be taken in the field of customs duties also. Raising import duties would divert the domestic demand from imports to home-produced goods and reducing or abolishing duties or giving export subsidies would increase the demand for exports and would contribute towards recovery from depression. It is obvious that a detailed tax policy should be more effective than a general one. Thus, it would be more helpful to lower tax rates on those goods which have a higher elastic demand. Demand should receive greater stimulus if persons with a higher marginal propensity to consume are given a relief in direct taxation. Similarly, for encouraging investment, specific tax concessions can be thought of—tax holidays, greater depreciation allowance and the like.

To counteract inflationary pressures, authorities still have to devise means to curtail the effective demand. Obviously, the authorities should begin by economising in their own expenditure. Quite a good amount of unnecessary and wasteful public consumption expenditure can be reduced. However, the freedom of the authorities in reducing public expenditure gets restricted when it comes to some important specific expenditures. It is generally found impracticable to retrench government employees for political and humanitarian reasons. Simi-

larly, quite a substantial proportion of welfare expenditure cannot be reduced. Actually, on account of rising prices there is a further pressure on the government to raise the salaries, pensions, and the scale of welfare expenditure. Even the normal expenditure of the government tends to increase on account of higher prices. Certain contractual expenditures like the interest payments on public loans are also there. All told, it appears that the government finds it more difficult to reduce its expenditure during inflationary periods than to increase it during a depression. To what extent can taxes be used to counteract inflationary pressures? In this connection we would consider two questions. The first relates to taxes as built-in stabilizers and the second relates to the common belief that taxes can be used to curb prices and demand.

Taxes do act to some extent as built in stabilizers. Given the level of government expenditure, the tax system itself tends to create a budgetary surplus during a boom and a deficit during a depression (A budgetary surplus would curb expenditure and demand while a budgetary deficit would have the opposite effect and thus an anti-cyclical effect is created). This happens because revenue from indirect taxes is dependent upon the level of economic activities. Similarly, revenue from direct taxes would depend upon both the income generated and the level of economic activities. Moreover, direct taxes are usually progressive. With increasing money incomes the direct-taxes bill rises more than proportionately and during a depression there is a more than proportionate reduction in it. Therefore, yield from these taxes also moves in line with the level of economic activities. The result is that during a depression, tax revenue falls, and with given government expenditure, there is a budgetary deficit, which in turn has an expansionary effect. On the other hand, during a boom, the tax system yields a larger revenue causing a budgetary surplus which has a contractionary effect. However, we should note that the authorities cannot rely upon this built-in-stabilizing effect of the tax system and the effort needed for economic stability is far larger than the automatic change in the tax bill. During a boom, for example, the market may develop expectations that prices would rise still further and tax measures are not likely to curb speculative demand and prices in this case. Similarly, unless producers expect that their investments would be commercially profitable, they would not invest during a depression even when tax rates are lowered. It should be noted that even in developed market economies, market imperfections are increasing. This phenomenon has tended to reduce their adjustability and responsiveness to tax measures. Such limitations

of tax devices become more glaring in underdeveloped countries. These economies are riddled with extra rigidities and they have limited scope for the use of direct taxes. Accordingly, in these countries, the authorities have to rely to a larger extent on non-taxation measures like import quotas and price controls. Even within the tax system, reliance has to be had on indirect taxes on a selective basis.

All told, it is found that the fiscal policy has far more chances of success during a depression, but much less in an inflationary situation. In either case, it will be better if the fiscal policy is helped with appropriate monetary and other measures.

In underdeveloped countries, however, the aggregative role of fiscal policy is limited since such economies do not have enough of flexibility and tend to develop pockets of inflationary pressures. In this case, the government has to devise more particular measures of taxation and expenditure, coupled with additional selective credit controls, etc., to help the economy. In the field of foreign trade also, its exports and imports are likely to suffer from low elasticities and, therefore, the use of customs duties and subsidies has to be supplemented with that of physical quotas, licences, and so on.

Fiscal Policy and Economic Growth

Budgetary flows form an important portion of the flow-of funds of an economy and, therefore, have a profound role in directing the working of the economy. Even a developed country cannot afford to stagnate or decay. For it also a steady increase in national income and employment is very desirable. Stability of the economy helps it in achieving this objective because the investment decisions are affected more favourably under conditions of stability (an investor is interested in both the rate of the returns as also its 'safety' and 'stability') and with stability the consumption expenditure also does not fall below a level and forms a cushion for the economy. However, it is not necessary that the objective of stability of income and employment at a high level should always be in harmony with that of maximum growth rate. This is because the long run growth rate to a large extent depends upon the rate of capital accumulation and the development of the capital goods sector. A high level of stable employment might be achieved through encouragement of 'unproductive' investment and expenditure on the part of the government. In other words, such a level of employment might be achieved and sustained on the strength of a high consumption level rather than a high investment one. Thus, a short-run policy of achieving stability at a high level of employment would be helpful for economic growth but need

not be the *best* from the long-run point of view also.

The contrast becomes clearer in the case of underdeveloped countries. Here there is an express need to accelerate the process of capital accumulation for which, therefore, it is the capital goods sector and the social overheads which are to be given priority. Furthermore, capital goods industries are generally capital-intensive and generate proportionately a lower employment. The contribution of these developmental efforts, therefore, would tend to militate against the short-term objective of increasing employment in the country. On the other hand, if employment-oriented, labour-intensive industries are encouraged, there will be a large increase in the consumption demand and this will retard the process of capital accumulation.

The market mechanism in an underdeveloped economy is not likely to be able to generate enough of savings and investment needed for a rapid economic growth. Had this been so, there was no need to think of fiscal policy as an explicit instrument of growth. For this reason, the government budget has to assume a leading role in effecting savings in the economy. Whether or not foreign capital can play a significant role in supplementing the budgetary savings of an underdeveloped country depends upon the specific circumstances of the situation. But in general, reliance upon foreign capital can be placed only up to a limit and no more. Budgets have a more direct role to play in capital accumulation and economic growth in an underdeveloped country than in a developed one. As it is, the saving potential in an underdeveloped economy is very limited partly because of the shortage of particular resources, partly because of the lack of adequate demand (especially of capital goods), and partly because of high cost of production. This vicious circle can be broken through the government effort at development. For this, the budgets have to be savings-oriented for the economy. Also the budgets themselves would have to be designed in such a way as to yield investible surplus in the hands of the authorities. Such investible surplus could then be directed towards the building of social overheads, creation of basic and key industries, and so on.

It has to be noted that the governmental effort at developing the economy does not have to be limited to the public sector only. So far as the market mechanism and private enterprise are permitted, they must be induced to contribute their share to the development of the economy. More specifically, the authorities should have a definite policy of encouraging the growth of particular industries and in particular areas (so as to reduce the regional imbalances). For this purpose, there should be specific tax concessions and subsidies such as tax holi-

days, higher depreciation allowances, etc.

It is essential to note that the development of capital goods sector adds to the inflationary pressures. This is because while the demand in the market keeps on increasing on account of the generation of additional money incomes, the supply takes time on account of the long gestation periods in capital goods industries. Deficit financing has a special role to play here it can be used in accelerating economic development, but it has to be prevented from helping inflation. Since direct saving capacity of the people is limited, therefore, the authorities find it easier to resort to deficit financing for the purpose of financing the growth of public sector. There are two forms of deficit financing here—and both may be resorted to in combination.

Firstly, the government may borrow from the market. This procedure is equivalent to transferring the resources straight from the private hands into those of the government. Normally, the scope for pure market borrowings is somewhat limited in an underdeveloped country. People do not have enough to spare for investing in government loans. The market borrowings, therefore, generally amount to loans from various institutions and this means generally a diversion of investible funds from the private sector to the public sector. In other words, the market borrowings are not likely to add to the total investment in the country. However, a shift in investment would be there if the government investment plans are different from those of the private ones (and this is most likely to be so).

Secondly, the deficit financing, namely, resorting to the printing press, amounts to taking away a portion of the private sector's resources and leaving it with extra money. This technique can be used for re-allocating of the economy's resources and thus accelerating the pace of economic growth.

However, it must be remembered that market borrowings and currency creation by themselves do not guarantee that capital accumulation process will be strengthened or that inflation will be avoided. Actually, if government uses the market borrowings or currency creation to undertake various welfare measures or other consumption oriented expenditure programmes there might be a retardation of the growth process. Growth-oriented programmes may be divided into two portions. Some of them will be those which are quick results yielding ones such as minor irrigation schemes, reclamation of land and the like. There will be others like training and education of the working classes and development of the capital goods sector. Investment in latter types of programmes will add to the inflationary forces in the short-run and it is necessary that a proper corrective policy be

adopted to counteract that. In brief, we may emphasize that the budgetary investment policies will have both a 'multiplier' effect which will influence the aggregate demand and the 'capacity' effect (which will add to the production stream) in varying forms and with varying lags. It is, therefore, essential that the budgetary policy directed towards growth must incorporate elements of fiscal policy adjustments to avoid inflation or deflation. Thus, the investment programmes of the government designed to ensure growth would imply additional measures to bring about necessary adjustments between demand and supply of important goods and keeping the balance of payments on an even keel. This highlights the basic usefulness as also the limitations of the fiscal policy for economic development. The effective range of choice for policy-makers in the form of fiscal instruments may be much narrower than we might believe in the first instance. Furthermore, the budgetary measures designed for growth come up against problems of implementation, especially if there are various authorities participating in the task such as the ministry of finance, the planning commission and the local authorities. The conflicts and difficulties are further heightened when we think of the fact that a policy of economic growth is usually accompanied by additional objectives of social development and egalitarian ends.

Similarly, fiscal policy directed towards more equitable distribution of income and wealth will obviously be encouraging consumption and would divert the resources from investment. In this way, the objective of growth comes into conflict with those of distributive justice and containing inflation. Utmost skill is needed to design a fiscal policy which could achieve a proper balance between these objectives. It is obvious that fiscal policy cannot be expected to achieve a miracle. Other instruments of economic policy will have to be used along with for this purpose.

15 FEDERAL FINANCE

The Federal Set-up

A federation is an association of two or more States. The member States of a federation have the union (or Central) Government for the whole country and there are state (or regional) governments for parts of the country. In this set-up, thus, more than one government would be found for each region. It becomes a case of divided sovereignty for different governments which co exist. To put it differently, in a federal set-up, there are at least two layers of government. The top-most layer is the central or federal (or union) Government and below it lies the layer of state governments. The same principle may extend further and there are likely to be local or municipal governments within each state. However, generally, the discussion of the problems of a federal set-up is limited to the central and state governments only. The constitutional arrangements in a federation can vary and the exact governmental powers and obligations can differ in different federations.

In some countries, the states would be surrendering some powers to the federal government, while each state would have freedom of action and sovereignty in respect of all other matters. For example, the state governments, forming into a federation, might agree to come together and surrender to the federal government the functions of defence, currency and foreign relations only. All the other legitimate functions which a government may be expected to perform might be retained by these states. In such a situation, the federation is a creation of the states and depending upon the constitutional set-up, individual states might even be permitted to break away from the federation as and when they like. The other general way in which a federation might come into being is where the government of the country establishes regional or state governments and delegates various powers to them for the purpose of efficient discharge of those functions. The formation of such a federation may be stated to come about through fissiparous tendencies in the country indicating the lack of exact harmony of interests of different regions. Such a tendency is very likely to be there in a big country where the regional differences exist to a significant extent. Federations are suitable for those countries in which different ethnic and cultural groups occupy

reasonably distinct areas.

This system of political organization enables these different groups to maintain their identity and progress in their own ways, while still co-operating with each other. In between these two extremes, different degrees of cohesion may be found. Depending upon the circumstances which brought about the federation into existence, and the development of the relationship between the central and the state governments, it is possible that in some federations, the limits of powers may be defined for one layer of the government, the balance going to the other layer. Generally, the constitution of a federation would demand that no one layer of the government would be able to change its rights and obligations vis-a-vis the other layers unilaterally. It will have to be done through the mutual consent of the governments involved—often through a formal amendment of the constitution. Occasionally, of course, some changes in the mutual relationship might come about even through a reinterpretation of the constitution by the competent judicial authority of the country.

One form of limiting the powers of one layer of government and assigning the balance to the other layer has been noted above where the federating states would allow the centre to deal with only, say, defence, currency, and foreign matters. Another example would be the one where the centre delegates certain powers specifically to the states. In still other constitutions, the functions of both the states and the centre may be defined. In India, for example, the functions and powers of the Central and State Government are as given in the Union List, the State List, and the Concurrent List which gives those functions which overlap between the Central and State Governments. In some constitutions, similarly, the centre may have the authority to abolish, create or re-define the boundaries of a state.

Thus, a federation is not a static and rigid concept. It has evolved into different forms in different countries. However, one general tendency is noticeable. In most of the federations, the centre has tended to become strong in those matters which concern the whole nation while the state governments have tended to widen their sphere in matters of regional and local importance. In this way, even the unitary types of governments have moved nearer the federal form, while the federations have exhibited a tendency to develop strong unitary powers in certain spheres. In any case, no government, central or state, remains completely sovereign and this is the basis and spirit of any federation.

The Rationale

A question arises as to why should there be a federation at all in a country? Let us see the justifications for having such a set-up.

(1) *Efficiency*. One answer to this question lies in the complexities of a modern life in its various ramifications—political, economic social and others. And it is found that there are various duties and functions which can be more efficiently performed only at the federal level, while there are others which are best tackled at the state or even local level.

In the extreme there are some services which approach very closely the *pure* public goods and which have a good deal of externalities such as defence measures for economic stability and the like. The provision of such services should ideally be in the hands of the federal government rather than state governments or local ones. Similarly, those services which cover more than one state, such as inter-state transportation, communication, trade and commerce, are the subjects better suited for the federal government. These public services are meant to be consumed by the entire population of the country, or the population belonging to more than one state and to put these under the jurisdiction of any one state, or divide them between states would create unnecessary complications. The reason is that in such cases the costs and/or benefits of the service in question obviously spill over the boundaries of a state. It becomes difficult to have a proper cost-benefit analysis of such a service, to have a unified decision-making process and bring in a harmony between the cost-recovery and the paying out of benefits. On the other hand, there are some public services, the exact need for which is most likely to differ from area to area such as sanitation, medical aid and the like. From the administrative and other angles, such services should be left in the hands of the states and local governments.

In between the two extremes come those functions which pose a problem, and make it difficult to have a clear cut division between the central and the state governments. These are those functions which can probably be handled efficiently by both layers of government. Moreover, with the passage of time, it is possible that a function which was left to the states (or centre) is now found to be better suited for the other layer of the government. Such difficult cases would probably include education. Any division of such functions can be debated and questioned. In India, we have the Concurrent List of functions for both the Central and the State Governments. In such cases, however, care must also be taken that there is no duplication of efforts and no serious gap is left.

(2) *The Nature of Problems and their Solutions.* In a big country, there is likely to be a lack of uniformity in the problems faced by each region. The nature of their problems may defy a common solution. For example, each region has its own economic resources and potentialities as also the limitations which it faces. And an ideal solution would be the one which is in harmony with the cultural, social and political values of the people. In a big country, or in a country populated by different social and economic groups, therefore, the ideal economic, political and other solutions will differ. It would be best, therefore, to have a diversified pattern to suit the regional and other requirements. A federal set-up provides a greater scope for aspirations—political, social and economic— of different regions of the people to be translated into practice through the diversity that it permits in the set-up.

The Financial Issues in a Federal Set-up

Government activities have their financial counterparts, both in revenue and expenditure. Therefore, in a federation, along with the political problem of division of the functions as between different layers of the government, the issues connected with financial arrangements have also to be sorted out. It is generally stated that the power to spend should go along with the obligations and power to raise the necessary resources. This is considered more so because expenditure is a relatively more pleasant duty of the administration as compared with that of raising the revenue. It implies that a sound solution of the financial issues will ensure that the governments in a federal set-up have clear-cut tax bases which do not overlap. Between the federal government and the state governments, the tax power should be divided according to the identification of the tax bases while between the state governments even the same bases may be taxed but only within their respective jurisdictions. Thus, for example, if the federal government is imposing income-tax, the state governments should not do the same. However, taxes like land-tax can be imposed by all the state governments since here the territorial boundaries of one tax levying authority can be distinguished from those of the other.

In practice, however, it is not always possible to avoid taxing the same base by two or more governments. And sometimes, another problem may arise in the form of what is termed as a tax competition. One state government may reduce or abolish certain taxes (such as sales tax) in order to attract trade and manufacture from other parts of the country. This type of competition is not always bad, of course. A backward state might find it a useful incentive to attract capital

and thereby help bringing about economic growth. Therefore, whether or not tax competition in any particular situation is unhealthy will depend upon the merits of the case and no *a priori* generalization can be made in this connection.

Another aspect of the problem of federal financial relations may be stated as follows: To allow and expect a government to perform certain functions means expecting it to spend the necessary amounts. If the government is not able to raise the necessary funds, it obviously cannot perform these functions. A limitation on the available resources would be a limitation on its power to spend and hence perform that function. But to let it have resources without any legitimate controls and discipline would also be not desirable. If, for example, the Central Government agrees to finance all the specified activities of the state governments irrespective of the extent of expenditure, the state governments would tend to over-spend. There would be wastage and inefficiency also. This leads us to look for particular rules and guidelines for dividing the financial powers as between different government units.

Principles for Efficient Division of Financial Resources between Governments

(A) *Efficiency*. Different sources of public revenue can best be handled at different levels. Some sources of revenue are, by their very nature, national in character, while some are of regional or even of local character. For example, if we take the case of income-tax, we find that to let this source of revenue be in the hands of state governments would create many anomalies and complications.

Firstly, income-tax rates and exemptions are likely to differ if different states are given authority to fix their own schedules and exemptions.

Secondly, in a large number of cases, it will be difficult to demarcate the jurisdiction of various states in a clear cut manner.

As individual (or a firm) might be getting his (or its) income from more than one state. Or the income may originate in one state while the individual (or the firm) may be a resident of another state. A still more complicated case will be where even the origin of an income cannot be easily identified. For example, a trader resides in State A, buys goods in State B, and sells them in State C, and thus earns a profit. Which of the three states is entitled to tax him? Apart from the problems of identifying the origin of income, such a situation will also make it difficult to get hold of the tax assessees and tax evasion will be a real problem. Similar difficulties will be faced if we think

of the wealth, gift, expenditure and many other taxes. The problems of valuation of the taxable amounts involved, and the problems of jurisdiction all get mixed up in these situations. For these reasons, it is thought best to assign such direct taxes to the federal government. There are similar other taxes which, because of their multiple association with different states, cannot be left in the hands of the states such as inter-state trade transactions. Customs duties, for example, are collected only at certain points from where they are supposed to leave the country, but the goods could originate in any state. Similarly, in a modern economy, a number of regulatory and protective financial powers have to be left with the federal government. One may mention here the currency and coinage, international capital flows, foreign aid, and the like. These things are assuming greater importance with expanding international economic relations.

Certain financial sources will be better left with the state governments for efficient scheduling and collection. Examples may be given of land revenue, small scale and cottage industries, dairy farming, road transport etc. Some sources of revenue should preferably be left in local hands; for example the income from water rates, house taxes, city transport and the like.

(B) *Economy*. Like the canon of economy for the selection of the taxes, the assignment of various financial powers to different governments should also be with reference to the economy in the cost of collection. A non-economical and expensive way of collecting a revenue would be wasteful for the economy, and no economy is rich enough to waste its resources as such.

(C) *Desired Effects*. Again it is found that a number of collective and other actions have to be taken which will be of local nature and which will vary significantly over different areas. The rates of house taxes, for example, need not be uniform in all cities. They are best decided by the municipal authorities themselves. Similarly, fiscal measures designed to bring about stabilization in the economy will be more effective if designed and implemented at the federal level. To prevent the economy from a balance of payments disequilibrium and the like, a policy of customs duties can be helpful at the national level. Regarding the industrial policy designed to help the over-all growth of the economy, it is the national action that is needed: but to reduce the regional disparities, state actions can also be employed. Fiscal efficiency in terms of collection, and variations of coverage and schedules will thus often point towards the way the financial powers should be divided between different governments.

(D) *Adequacy*. Seligman emphasized the criterion of adequacy

when he said that "the three principles that should guide in the allocation of revenue as among various tax jurisdictions are: the extent of the base of the system, the efficiency of administration ard the adequacy of the revenue."[1] However, the adequacy of revenue should obviously refer to the adequacy of the *total* revenue availability to a government and in a federal set up, even that may come in conflict with the criteria on the basis of which functions are assigned to different governments. Of the two, these days, the efficient allocation of functions is given a priority and the financial adequacy is sought to be adjusted through other means like tax-sharing, grants and loans.

As a general rule, however, we can mention some of desirable results which should be achieved so far as possible while dividing the financial resources between the federal and the state governments, and as between the state governments.

Firstly, the tax coverage and tax schedules should avoid being discriminatory as between citizens of the same country residing in different states, unless of course, the over-all national policy dictates so, say, on welfare grounds whereby resources ought to be transferred from the more to the less advanced states. *Secondly*, assuming that there is no specific problem of regional imbalance, the tax structure should be as uniform as possible as between different states. The states should avoid unhealthy tax competition and should therefore not come into conflict with each other.

Division of Functions

We have already made some observations in this regard showing the diversity of functions which a modern government is expected to perform and therefore the rationale of having different layers and divisions of the governmental authority in the country. We can elaborate this further by pointing out that on grounds of efficiency and economy of administration, it is preferable to divide the functions between the central and state governments. We have seen, in general, how some governmental functions may be performed more efficiently at one level while others may be more suitable for other levels. But apart from this, there is the problem of inter-state divergence also which would indicate the desirability of assigning different responsibilities as between different state governments. The nature of problems faced by Rajasthan, which has expansive desert areas will be different from the problems faced by Bengal or hilly states like Himachal Pradesh. The character of economic, political

[1]E.R.A. Seligman, *Essays in Taxation*, 10th edition, p. 669.

and social set-up differs as between different states, and therefore a number of problems can be more efficiently solved at state or even local levels.

The Problem of Financial Imbalance

The above discussion of the proper division of functions and resources shows the problem of imbalance—at the aggregate level, as between the centre and the states, and as between the states themselves.

Let us first look at the imbalance at the aggregative level. It highly unlikely that the duties (responsibilities) and financial powers would be in harmony at different levels of government. To begin with, it must be noted, that even for the economy as a whole, it is very unlikely that the needs and the availability of resources will match. In an earlier chapter, we have seen various reasons for this.

Firstly, as Wagner and Wiseman-Peacock hypotheses show, there will be an upward trend in public expenditure. The balance between the expenditure and revenue, even if it is attained once, is not likely to stay. And Wiseman-Peacock thesis supports this possibility in a much stronger manner.

Secondly, cyclical fluctuations and other disturbances in prices, income and employment, natural calamities and other emergencies etc., would be causing an imbalance between the two

Even if there is an over-all matching of the resources with the needs, there is no reason to believe that such will be the case at state and federal levels separately as well. "It so happens that the distribution of functions by performance criteria and of powers by economic allegiance tests do not lead to even a roughly satisfactory balance between own-revenue and expenditure of most of the federations."[2] The nature of revenue resources best suited for one level of the government need not conform to the nature of the requirements of that level of the government. Similarly, even with the similar financial powers, one state government may find them inadequate while the other may not. Actually, as we shall see below, there are chances that there will be quite a good deal of discrepancy, at least on welfare grounds. The discrepancy as between the resources available to the centre and the states increases due to the fact that on account of efficiency, economy and other criteria the centre gets those resources which are elastic in nature while the states are mostly saddled with

[2]D. T. Lakdawala, *Union-State Financial Relations*, Lalwani Publishing House, 1967, p. 3.

inelastic revenues. For example, in India, income and corporation taxes are with the Union Government. The yield from these taxes tends to increase along with an increase in national income. Another lucrative source of revenue to the Central Government is the Union Excise Duties. The States, on the other hand, have mainly inelastic sources such as land revenue, etc. Between the states also, various factors contribute to the discrepancy between their revenue resources. The level and composition of income in different states may vary widely. Those of them which have industries would be able to yield larger revenues by way of sales taxes, etc, while those depending mainly upon agriculture will not be so fortunate. Similarly, the extent and intensity of trade, commerce, and allied services differ from area to area. Bigger commercial centres are obviously able to lay their hands on more revenue than the areas which are backward in this respect. And peculiarly enough, the revenue *needs* of the economically advanced states are comparatively (as a proportion of the income of the state region) lower. In less developed areas, there is an all-round need for improving social services, providing social overheads, improving health, establishing industries and the like. To put it differently, the marginal utility of each rupee spent by way of public expenditure in lesser developed states will be more while it will be less in the case of more advanced states. On the other hand, the marginal disutility of each rupee raised by way of public revenue will be higher in the backward states.

Now a distributive justice is as much called for between regions of the same country, as between different members of the society. This justice implies that whatever be the level of governmental activity, the marginal disutility of taxation should be the same for different regions and similarly the marginal utility or benefit of government expenditure should also be the same. Since a backward region needs much larger amount of state services than it has at present, its marginal social utility from governmental services is far greater. In a backward region, therefore, the public expenditure should increase -if need be, even by transferring the resources from the more advanced regions. Similarly, when it comes to collecting the tax revenue, it is relatively better off regions which should pay more because of the lower social marginal disutility or sacrifice of tax. Eventually, inter-regional justice would demand that the richer regions are taxed more and the tax collections are transferred (partly) to and spent in the poorer regions. Thus, a resource transfer should take place. Though we are not able to measure the social disutility and social utility of taxation and public expenditure, still a reduction in glaring regional inequalities will

certainly be helpful.

It is very unlikely that the advanced states within a country will voluntarily agree to transfer adequate resources to the poorer states. For such a transfer, a political set-up in the form of a strong federal government would be helpful and probably even necessary. The federal government should have, therefore, resources much larger than its own requirements (and a larger share of these resources should be coming from the more advanced regions of the country) so that it transfers them to the poorer regions for their levelling up. A strong centre is also needed for political integrity of the country, which in turn will again imply larger resource availability to the central government.

Federal Financial Adjustments

The conclusion that in a federal set-up, there is likely to be an imbalance between the needs and resource-availability of different governments, leads us to look into the problem of financial adjustments between them. As we have noted, such a problem of financial adjustment normally implies transferring of resources from the central government to the state governments and from some regions of the country to the others (again generally through the medium of the central government). Given the over-all resource position, two issues have to be sorted out in this connection.

Firstly, the relative needs of states vis-a-vis the needs of the central government have to be determined. A scheme has also to be evolved whereby the relative needs of the states vis-a-vis each other are quantified. Both dimensions of this problem are interlinked and one cannot be solved without reference to the other.

Secondly, the precise methods and techniques of resource-transfer have to be decided and implemented.

Let us take up the first problem to begin with. Some of the functions of the central government are such that discussion about the legitimate extent of public expenditure on them can be very easily inconclusive. One can only mention a general range within which public expenditure on such functions should be undertaken. Thus, it is difficult to decide a 'proper' amount of defence expenditure. It will all depend upon the circumstances attending upon the question including the total resource availability, the international atmosphere and the like. In the event of an actual war, defence would obviously get the top-most priority. Same is the case with various other functions also which the central and state governments are expected to undertake within their respective spheres. One may look at the problem from the point of view of dividing the total governmental activities into capital accumu-

lation and growth, social services, and so on, and then formulate an idea as to what is the relative weightage which each of these main categories is to command. In practice, of course, the relative weightage will tend to follow a pattern that already exists and only marginal changes, (if at all), are likely to take place. Anyway, having decided about the relative weightage, it can be estimated as to what portion of these services is to be performed by which government, and the resource entitlement can accordingly be worked out.

We must remember that this type of approach sounds all right only on paper. In practice, it is surrounded with all sorts of difficulties.

Firstly, there are some fixed and contractual payments which no government would be able to avoid such as interest on public loans, salaries to its employees and the like. Again, even if it is agreed that the administration is too expensive, not much can be done to reduce its expenditure (though care may be taken that it does not increase as fast as the expenditure on other services do).

Secondly, such a fixedity of expenditure also comes in the way of inter-state division of resources. Thus, a state which has a developed educational system and other civic amenities is already committed to a certain amount of expenditure on these services. Therefore, out of a given amount of expenditure which ought to go to these services, this particular state just appropriates a lion's share while the needs of other states are obviously more.

Thirdly, with claims and counterclaims, it is ultimately a matter of opinion and judgement as to what sphere of activity should command what portion of the total governmental resources. Not only economic but many other influences will also go to decide the resource allocation.

Fourthly, it is very difficult to agree upon the criteria and their relative weightage while deciding about the inter-state distribution of resources. For example, if we take the case of the central government giving grants-in-aid to the state governments, what should be the criteria, on the basis of which their relative shares are to be determined? The first impulse here is that it should be the population of the respective states. But a little reflection shows that the population criterion has many flaws. The needs of a region for governmental services does not depend upon the size of its population only. It equally depends upon the population density, topography of the region, the climate, fertility of the soil and many similar factors. Moreover, in a country like India, where population control is an urgent need, adoption of population as the basis of distributing the resources would sabotage the population policy. Another basis for the adoption of

resource division could be the per capita income of the population within each state. Such an approach, however, implies that within each state there is a reasonable uniformity of income distribution. It, however, may not be the case. For example, in UP State we find that the eastern districts are quite poor compared with the western ones. The criterion of per capita income would under-estimate the needs of the eastern districts. The criterion of per capita income suggests that the poorer states should get a larger share of the resources, but ignores the problems of their absorption (that is the capacity of such states to utilize effectively these additional resources). The absorption capacity can be developed only slowly and therefore indicates the need for a gradual removal of the inter-regional disparities.

Fifthly, if the relative sharing of resources is decided on the basis of the respective needs of the states in relation to their current resources, a number of them are likely not to put in the desired tax effort. They would avoid imposing additional taxes, revising the rates of the existing ones to the new rational levels, and might even deliberately ignore tax-evading attempts of the public. Thus, those states which are quite vigilant and vigorous at raising the resources would suffer in comparison with those which are lethargic and inefficient. It implies that an objective criterion of deciding what a state could be legitimately expected to raise by way of revenue resources must also be evolved. But such a task is not an easy one. Only some imperfect solutions can be expected in this direction. It should also be remembered that any scheme and set of criteria adopted for sharing and transferring the resources between different governments is not likely to be suitable for all times to come. By the very nature of the issues involved, the whole system should be flexible so as to be able to cater to the changing circumstances and requirements.

The second problem, as mentioned above, is the choice and use of the instruments and methods of restoring the resource-balance between different governments in a federal set-up. Here, the following main methods may be used: (1) Tax-sharing; (2) Grants-in-Aid; and (3) Loans.

(1) *Tax-sharing*. This system refers to the practice where a tax (or taxes) is levied by one government and the proceeds are shared by two or more governments. Generally, this is the case where the federal government imposes and collects a tax and then the tax proceeds are shared with State Governments. Such a practice might be needed on grounds of efficiency of tax administration including *uniformity* of rates, and plugging of the tax evasion. Imposition and collection of a tax by a single authority could be justified on grounds of *economy* of

tax collection also. Again, when a particular tax covers economic activities or properties etc., spreading over two or more states, it is always more desirable that the federal government should levy and collect the tax. Such a procedure has other advantages also. The federal government could share with the State Governments the proceeds of those taxes which are quite elastic and thus meet the objection of the states that they are left with only inelastic revenues. Thus, in India, the Central Government shares with the State Governments the proceeds of the income-tax and union excise duties. Another form of tax sharing can be the one where the central government which collects the tax does not retain any part of it and distributes all the proceeds amongst the state governments. Thus sales tax involving inter-state sales transactions may be collected by the Central Government and the proceeds distributed amongst the states according to some principles.

We must note that in tax-sharing (with given percentage shares),the combined amount going to states will depend entirely upon the proceeds of the tax—usually net of the cost of collection Within the divisible pool, the share of each state, however, will depend upon the percentage share assigned to it. The states, therefore, share the benefits or losses of changing revenues which an elastic tax is likely to exhibit.

It must be remembered that tax-sharing should be done on some rational basis. In India, for example, the need for an over-all revision of the tax-sharing is recognized and the President has to decide about the sharing of the prescribed taxes between the Centre and the States as also amongst the States themselves on the basis of the recommendations of the Finance Commission which must be appointed periodically. Of the various possible principles of tax-sharing, some cannot be recommended strongly—such as, guaranteeing certain minimum absolute amounts to particular governments, or granting a fixed amount to one government and the balance to the other. Tax-sharing ought to be subjected to objective criteria and revised according to the needs of the times.

In general, two approaches might be adopted in determining the shares of the states *inter-se* in the total divisible pool. The first approach makes use of the tax collection originating within the jurisdiction of respective states. The second one considers the tax base itself. The two approaches can yield quite different results. For example, in the case of income-tax, two states may have the same number of tax assessees (that is equal bases), but the tax collection may be larger from one (in which richer income-tax payers reside) than from the other.

A scheme of tax-sharing might be all right for the time being, but

its correctness cannot be guaranteed under changed circumstances also. It is always preferable to have a flexible system which could be adapted to suit the changing needs of different constituent parts of the country's government. Furthermore, from the point of view of efficiency of collection, it is always desirable that the tax collecting government is entitled to some share in the proceeds of the tax as well. Otherwise, it is likely to be lethargic in its duties. Furthermore, in order to keep the system within manageable limits it is better not to spread the tax-sharing scheme to too many taxes. It is preferable to concentrate in the main on some important and elastic revenues like income-tax.

(2) *Grants-in-Aid.* Though theoretically grants-in-aid can be from any one government to the other, in general it is the central government which gives grants to the tsate governments because mostly the states have deficient resources in comparison with the services which they have to provide Grants-in-aid can be used to serve many purposes in a federal set-up. Thus, the very idea of helping the states with deficient resources implies that grants are a means of bringing about a balance between the functions and resources of the government at different levels, and in each state Grants are basically meant to meet the additional "needs" of the State Governments arising out of the services they are expected to provide but for which they are not empowered to raise enough resources. In some cases, it may even be found desirable that one or more states should be performing certain services but without burdening the state population with extra taxation (even if they can). For example, during a depression, the State Governments may be induced to spend more without collecting more of tax revenue or raising additional loans from the markets. Similarly, they may be helped to provide relief against famine, drought, floods, and the like, without taxing the people further.

Another important function of grants is to help the country in reducing regional disparities. Such grants, in a relative sense, would be loaded in favour of the backward regions of the country. These grants can be conditional in the sense that they may be given for specific purposes only. By making them conditional, the federal government tries to ensure that the purpose of such grants is served. A grant with the intension of developing an irrigation facility should not be used, say, for office buildings. It may further be added that grants meant to help the relatively backward regions of the country are not just acts of charity. They are indirectly beneficial to the better-off regions as well. A backward region is a drag upon the whole economy. And it is in the interest of the better-off regions that the backward ones should

also experience economic improvement. They would be generating an economic feed-back process. Further, as the economies of the backward regions are pulled out of their stagnation, they will no longer remain in need of extra grants.

Grants-in-aid may be in place of or in addition to the tax-sharing. In India, Grants-in-aid are given by the Central Government to the States under Articles 273, 275, 278 and 282 of the Constitution and are determined on the recommendations of the Finance Commission. These grants are in addition to the tax-sharing between the Centre and the States. Grants can be of various forms. Some grants, as seen above, could be to compensate the States for the loss of certain revenues In India, for example, the Central Government gave grants under Article 273 to compensate for the loss of revenue on account of the federalization of export duty on jute and jute products. Similarly, under Article 278, the Government of India gave grants to the erstwhile Part B States for the net loss of revenue on account of their financial integration with the Union.

Some grants may be general in the sense of a general contribution to the revenues of the states and may be called fiscal-need grants. They are intended to help the states to overcome the overall inadequacy of revenue in comparison with their expenditure needs. In India, the Union Government gives such grants under Article 275(1). In addition to the above, the Union Government may also give grants to the States for the development of Scheduled Tribes and areas under provisos to Article 275. Furthermore, there can be discretionary grants also, which may be sanctioned for any purpose. In India, Article 282 of the Constitution empowers the Government of India (and the States) to give such grants, notwithstanding the existing distribution of financial resources and the Finance Commission is not authorized to deal with these grants. The Government of India gives conditional grants to States usually under this discretionary power for specific purposes like flood relief, Plan schemes and the like.

Conditional grants are always meant for specific purposes. For example, the need for particular projects or schemes may be recognized but the State Governments may not be in a position to spare resources for these schemes. There may also be a possibility of a State Government utilizing the grant for a purpose other than that for which it was meant. In such cases, conditional grants would be a better choice. A conditional grant may be additionally a matching grant also, meaning thereby that the amount is granted subject to the condition that the recipient government also contributes a specific amount or percentage (in cash or kind) for the scheme (or schemes)

under question. Conditional and matching grants, however cannot be justified in every case. If every grant is conditional, then there is a danger of the total resources of the state being used sub-optimally. It is often better to allow the state freedom in dividing its total resources, including grants, in the best possible manner it can. Conditional and matching grants would be necessary only where the rationale of some schemes is well established but where it is found that the state government would give them a low priority. In general, however, conditional and matching grants tend to breed inefficiency and wastage. For example, if in a particular scheme the State Government has to spend only 20% of the cost, while the Central Government gives the remaining 80% as grant, the State Government is likely to underplay its cost while deciding to take up the project. In conditional and matching grants, therefore, utmost care and vigilance by the grant-giving government would be needed. No grant-receiving government should feel free to use the grant funds wastefully. Both the donor and donee governments have to realize their responsibilities. This is a delicate task but it must not be lost sight of. Too niggardly a grant will scuttle the purpose for which it is given and too large a grant will encourage irresponsible and wasteful expenditure.

(3) *Loans.* They have a special place in the federal set-up. If it is found that a state should undertake a particular project and that the project is expected to pay for itself through an income partially or fully, then instead of a straightaway grant, the federal government may give a loan for financing the project. A loan, in other words, becomes a kind of investment loan which is supposed to be paid back out of the earnings of the project. The state government would also be probably more careful about the running of the project if it has been loan-financed than if a grant was received for it. It is, of course, clear that the amount of such a loan need not cover the full cost of the project. Also the interest rate could differ from the one on which the government could borrow in the market. In a number of cases, such an interest rate would be somewhat lower.

It is not necessary however that the loans should be project-tied, or must be used only for particular projects. It is quite possible that just as the federal government could be in need of loans from the market or from the central bank, similarly, a State Government might find its revenue falling short of its requirements. The need might suddenly increase on account of some natural calamity or a shortfall in the expected tax receipts and the like. To tide over such situations (in which the State Government is ordinarily expected to look after itself) the centre might agree to extend a loan to the state government.

Alternatively, loans from the central government might take the place of normal market borrowings. In India, for example, the State Governments borrow only limited amounts from the market; but they have been extensively borrowing from the Central Government and as a result have become heavily indebted to it.

It is clear that no single adjustment device would suit all the circumstances and all the cases. The whole approach of the financial adjustment should be based upon realism and objectivity and should be amenable to a review whenever the circumstances so demand.

16 PUBLIC UNDERTAKINGS

MEANING

We should distinguish between public sector of an economy and the public undertakings as such. The government activities form a significant proportion of the total economic activities of the economy, and therefore, make an important contribution to the flow of funds, consumption, employment, and the like. In the public sector, we shall include the government administration, defence and similar public services including commercial and non-commercial undertakings of the government. This concept of the public sector is helpful when it comes to ascertain the role of the government in the working of the economy. This approach runs in terms of the allocation of resources as between the private and public sectors and the policy issues and effects corresponding to any shift between them.

Public undertakings, however, need not be equated with public sector as such. The form a part of the public sector. Public sector services may be divided into three parts:

(*i*) Those public services which are provided free of cost to the members of the society (or where that is more or less the intention) such as defence, administration, justice, law and order. These services tend to approach pure public goods;

(*ii*) Those public services which are run and maintained by the Departments or as Departments. Examples are of postal services, education, certain public utilities, roads and bridges etc. These services are financed and run on different criteria so that some of them may be in the nature of commercial undertakings also;

(*iii*) Those public services which are provided not by the Departments but through the means of autonomous or semi-autonomous bodies like firms, companies and corporations. These economic units, though owned by the government, may have their own price policies according to different objectives and criteria.

Though it is not always easy to draw a clear-cut line of demarcation between public undertakings and the rest of the public sector, it is generally agreed that the undertakings providing services in categories (*ii*) and (*iii*) above only constitute public undertakings. It might, how-

ever, be mentioned that even in category (*i*) the government might charge fees for some services (for example, court fees, or licence fees etc.). But such fees would be more in the nature of taxes and for regulating the supply of services on certain basis. Furthermore, the terms, undertakings and enterprises sometimes cause confusion. It is felt by some that probably a public enterprise is more like a private enterprise where there is a risk and there is an intention to reap a profit, while a public undertaking need not be risky and it need not work for profit. This distinction is not a basic one. We shall use the two terms interchangeably and state that whether or not a public undertaking faces risk like a private enterprise depends upon numerous circumstances like the product it supplies, the market structure and so on And a public undertaking may or may not have a policy of making a profit. A choice of price or profit does not make it one or the other. One thing, however, we should remember. There have been some goods which we, in line with Musgrave, may call the 'merit goods'. They are supposed to be essential for a proper and decen life of the community and therefore, such goods and services have been traditionally called public utilities (like water, city transport, and the like). Such public utilities may be in the hands of private sector (as has been the case quite often), or they may be in the hands of the authorities in which case they *also* become public undertakings. Thus, a public utility need not necessarily be a public undertaking and vice versa. Because of their recognized importance in the life of the community, the working and price policies of these public utilities have been subject to governmental control and regulation even when they are in private hands.

The growth of public undertakings has been partly by nationalisation of the existing concerns and partly through the creation of new ones. In advanced countries, public sector has expanded to a large extent, by taking over of public utilities. In countries like the UK, where the ideals of social security have gained a rapid currency, certain key industries were nationalised as a matter of policy. In many underdeveloped countries, objectives of rapid economic growth, industrialisation and a socialistic pattern of society have led the authorities to nationalise many private enterprises. In some cases, as a matter of national policy, some sectors have been reserved for the public sector. In India, for example, the government's industrial policy reserves airways, defence industries, new steel mills, and the like for the public sector. Similarly, even the official help to stimulate private sector of the economy may gradually work towards the expansion of the public sector—firstly, through the establishment of

public financial institutions and secondly, through the eventual financial control and ownership of the concerns financed through them. However, we may add that "in most developing countries the public enterprises sector is in a formative stage Expansion has tended to be vigorous rather than orderly, particularly in the countries where governments face urgent development tasks which, by necessity or by choice, are entrusted to public enterprises."[1] In the case of many underdeveloped countries, it has been sought to replace the private enterprise undertakings by public sector undertakings. It has been partly prompted by an over-estimation by the authorities of their own newly acquired administrative powers and capabilities in the wake of Independence. In some cases, a dislike for private enterprise (which was in some cases the offshoot of a dislike for the colonial rule) itself has reinforced this desire to liquidate private enterprise and institute in its place the public enterprises.

Rationale

The need to have public undertakings can be justified on a number of grounds.

(1) The first justification for public enterprises was provided ironically by the advocates of free enterprise like Adam Smith. It was realized that in spite of all its advantages, a free price mechanism had serious limitations which had to be overcome in the long-term interests of the economy. We may be able to ignore some of these limitations but not all. An economy cannot sustain itself and grow unless it is healthy in terms of production potential which should increase with the passage of time. With the advent of industrialisation, and therefore a more rapid rate of economic growth, it was essential that the economy should be able to sustain its increasing productive capacity. This implies development of different economic sectors in harmony with each other, that is, a proper sectoral balance. However, the nature of market mechanism is such that all economic activities are guided by economic "rationalism" which in the case of provision of productive services means profitability Market mechanism would refuse to create and run those productive services which could not yield adequate commercial profits. Now it is found that there are some means of production like social overheads, the creation and maintenance of which does not ensure adequate commer-

[1]United Nations, "Measures for Improving the Performance of Public Enterprises in Developing Countries," Vol. I, *Report of a Working Group*, 1969, para 24.

cial returns. Such social overheads, however, are necessary for the development of the economy. They are a major source of external economies and therefore help towards unleashing the productive forces of the economy. Their development lowers the cost-price level and stimulates economic growth.

In this way, social overheads formed the first category whose creation and maintenance as public undertakings was theoretically justified. The public authorities could maintain these overheads at a loss and meet the loss from their tax revenues. In some cases, of course, it might be practicable to collect some revenue by way of fees and the like, but in general these social overheads would be non-profitable undertakings.

(2) Furthermore, most of these social overheads and other basic and key industries need huge amounts of investment. Private enterprise is either not able to raise the necessary funds or is not ready to assume such large risks. In such cases, even if these enterprises could possibly be profitable, the government has to step in to establish these Cases of very long-term projects also come in this category. A society is expected to have an eternal life. It can and should take a very long-term view of the costs and benefits of a project, but a private enterprise will have only a limited horizon before it. Public authorities can, for example, invest in a multipurpose river-valley project which would yield benefits to the economy for, say, the next 400 years. But it is difficult to think of a private enterprise making an investment on the basis of such a long projection. A private enterprise would probably plan its investment and returns with reference to, say, not more than 50 years (though in practice it may live much longer).

(3) These days, most governments of underdeveloped countries consider it their duty to help in economic growth. Such a policy, in its turn, entails a number of responsibilities and some of these result in the governments going in for various types of public enterprises. The role of social overheads in accelerating the process of economic growth has already been noted, and it was seen that either private enterprise cannot invest in such projects because of huge investments, or does not because of commercial non-profitability or too lengthy a period involved. In an underdeveloped country, additionally, we find that there is an all round shortage of capital (leaving some countries like the oil-exporting ones). Underdevelopment is seen partly in the form of what may be called gaps of various inputs and a shortage of demand for certain items. Even the adequate availability

of capital in general does not rule out lack of *particular* shortages, skills and so on. It becomes, therefore, the task of the authorities to assume the responsibility of filling the gap and thereby removing the specific shortages. In the same connection, one may mention the role of basic and key industries, the development of which provides an impetus and a necessary base for the general economic development in diverse spheres. A proper and co-ordinated development of these basic and key industries necessitates a planning on the part of the economy so that over time, the economy acquires great resiliency and flexibility instead of getting saddled with greater rigidities and shortages. It is not very likely that private sector which moves solely on the basis of profit motive will find it always convenient to move ahead and establish these industries in time and in adequate measure. Such a danger of deficient performance is all the more there when it is remembered that some of these industries may not be profitable enough to begin with. Under such circumstances, it falls to the public sector to see these programmes through. Furthermore, provision of such gaps and also of creation of certain basis inputs like human skills through education and training will provide the necessary infrastructure to the economy without which it cannot grow. Actually, once such an infrastructure is provided, even private enterprise would find it easier and more profitable to expand at a rapid rate.

(4) The role of public undertakings in economic growth can be viewed from another angle also. Leaving out the details of the form and precise ways in which these undertakings may help the economy, we note that any economic growth is intimately connected with and dependent upon the economic surplus which the economy is able to create and the way that economic surplus is utilized. A number of public sector undertakings are themselves the capital assets of the economy such as roads, bridges, factories and the like. They are, in so far as they are not in the public sector by virtue of nationalisation only, *net* additions to the capital stock of the country and, therefore, they contribute to the total productive power of the economy. Such an addition to the capital stock of the country might take place through the utilization and exploitation of resources which were hitherto going waste; or they might result from the change in the allocation of the productive resources. Here again, public undertakings can help the economy a lot by diverting the productive resources into those lines which will accelerate the growth process later through a provision of an infrastructure, basic and key industries, and so on.

(5) It is a well-known fact that final choice of a project, in the interests of the economy as a whole, should depend upon the social

marginal benefit relative to the social marginal cost instead of the private marginal cost and benefit. There are a number of services the supply of which creates lots of externalities. Such externalities may be adding to social benefits or costs or both. If social benefits exceed social costs in the case of any service, then its production shou'd be taken up. But it is possible that while on grounds of social benefits some projects are sound, on grounds of commercial profitability they are not. Under such circumstances, these projects can be taken up by the authorities in the public sector.

(6) The case of merit goods also deserves consideration. Think of education or medical aid, for example. If left to private hands, the very demand for such services will be limited on account of their high prices. But it is generally believed that the supply of such services should be adequate and should be available at low or zero prices so as to encourage their consumption. In the case of education, for example, the government may not only provide it free, it may even insist that all the children up to a certain age must attend schools. Similarly, persons suffering from certain ailments may be forced to go to hospitals. Medical check-ups may be compulsory and general medical aid may be provided free or at subsidized rates. In still other cases, the government may force a particular service upon the members of the society and may charge for it (at full or subsidized rates). Street lighting, removal of garbage and the like may come under such category of services. In brief, we may say that these merit goods are expected to enhance the general welfare of the community and therefore should be provided through public enterprises either along with private enterprise or in place of it.

(7) The overall economic policy of a country also may dictate the use of public undertakings in some sectors. There are some industries like electricity generation, where there are economies of scale. Now if such a service is provided by a large number of firms competing with each other, it would not be possible to reap the economies of scale. On the other hand, if the supply of such a service lies in the hands of a monopoly, it may be against the economic policy of the country. Big monopolies are usually not looked at favourably because they quite often exhibit a tendency to exploit the situation to their advantage. It also causes a concentration of economic power in some private hands. Accordingly, authorities think it more desirable to have a public monopoly of such services in order to reap the economies of scale and also to avoid concentration of economic power into private hands.

(8) Another argument closely connected with the last one is where

effective economic control of the economy is sought to be brought in the hands of the State. In other words, the argument of not letting the emergence of a monopoly in the private hands is extended to the whole economy. The authorities here might plan to have a strategic control over the working of the whole economy through controlling certain key sectors. This is generally referred to as controlling the "commanding heights" from which, indirectly, the movements of the economy can be guided. For example, the government might nationalize foreign trade not because its intention is to displace the private sector as such, but because through it a wide spectrum of industries can be made to toe the official line. Similarly, the authorities can own industries like steel, cement, chemicals, electronic products, railways, airways, etc.

(9) In the case of some natural resources like forests, mines and the like, the commercial interests of private enterprise may come into conflict with those of the nation. Take the case of a private jungle contractor authorized to cut trees. He is likely to make a quick profit by cutting down as many trees as possible, if the terms of the contract and the market prices permit. This may result in a large scale and quick denuding of the land causing soil erosion and upsetting the ecological balance. On the other hand, if it is a government enterprise which is entrusted with this task, it can be expected to follow a well defined systematic policy of tapping the wealth of the woods and safeguarding the long-term interests of the economy. Similarly, private enterprise would tend to mine away to minerals as a fast rate provided the prices of minerals and the cost of mining make it profitable to do so. In some other cases, private enterpreneurs may not come to an agreement regarding the provision and meeting the cost of some necessary common services (for example, mines located close to each other might need a systematic pumping of the underground water) and this may cause a sub-optimal utilization of the resources in question. In all such cases, public enterprises appear to be the obvious answer.

(10) Apart from the above consideration which favour the creation of public undertakings, there are some projects which by their very nature have to be in the public sector. Currency and mint, for example, cannot be expected to be in private hands. Similarly, depending upon the socio-political structure of the country, some defence industries, certain research and development organisations and the like can be only in the public sector.

It is not necessary that in every economy all the above mentioned objectives would be at work in bringing about an expansion of the

public sector undertakings. The exact composition of the public sector undertakings, the pace at which they are created anew (or the existing ones are nationalized) and so on will depend upon quite a few factors including the political and economic philosophy of the country and the conditions facing it. Such conditions, for example, will include the administrative capabilities of the government, its economic relations with other countries, the balance of payments situation, etc. Similarly, economic and political philosophy of the government may be directing it towards displacing the private sector or encouraging it. The creation and expansion of the public sector in an economy need not necessarily follow a set of objectives which are consistent with each other or based upon sound objective criteria. The decisions bearing upon the role of public sector in an economy would be as much based upon non-economic considerations as the economic ones and it is also possible that the non-economic considerations may actually outweigh the economic ones. Furthermore, the objectives set by the authorities before themselves may be contradictory or too ambitious in which case some sacrifice has to be made in terms of scaling down the actual achievements or compromising between various objectives. In a number of cases, political and social considerations might lead the authorities to assume tasks far beyond their capacity or they may try to set targets which do not take into consideration the human limitations and the role of the natural elements.

Forms of Public Enterprises

Leaving apart the socialist countries, public enterprises first came up in the form of departmental undertakings. Most of these public undertakings were either social overheads or public utilities where the services were provided to the public either free or at such fees (or prices) which mostly necessitated subsidizing from the authorities. All public undertakings, however, were not meant to be run at a loss. Some enterprises like railways (and even post and telegraphs) were found having a price policy oriented towards profits for the government. Actually, in some countries a few enterprises were appropriated as state monopolies with the sole object of making them a source of profit for the authorities such as manufacturing and trade in tobacco products.

With expanding state activities and government enterprises, however, it was found that the departmental management was not always suitable. The departments were answerable to the legislature and were subject to set financial and other rules of the government. This necessitated long-drawn procedures for action. Initiative and quick-decision

in the light of changing circumstances, which are a hall-mark of an efficient enterprise, could not be ensured here. Right from the planning of any decision, strict rules were expected to be followed. Even small mistakes, if they infringed the set rules, were not to be tolerated while there could be a good deal of unchallengeable wastage by sticking to the rules. The limitations of departmental undertakings were felt more and more as the public sector expanded and its performance with the private sector compared. It was realized that departmental undertakings lacked an efficient system of incentives and punishment and that therefore some form of autonomy and responsibility to the management should be given to ensure efficiency and performance. This led to newer forms of public undertakings which conformed to the private undertakings in organizational set-up.

The enterprises which are not run on departmental basis have in general two forms. One such form is a firm or a company which is owned and controlled by the government and as such functions under the same laws of the country as the private firms or companies of similar type. Such a company, for example, may be a kind of single proprietorship or a partnership between various governmental organizations. Technically, it may be a private limited or a public limited company in which the government owns a majority of shares.

Another major form of public enterprises is what may be called the public corporations. A public corporation is set up by an act of the legislature. Its sphere of activities, rights, immunities and duties are governed by the provisions of the act creating it. It need not be a profit-earning institution. Technically, a corporation is "an artificial legal person." It can sue and be sued. Though it is wholly owned by the government, under the provisions of the relevant act, it can take independent decisions and can have its own personnel policy, management pattern and the like. It can raise additional funds by borrowing or in the course of its defined activities, excepting the share capital which is provided by the government at the time of its creation or nationalisation. It is, however, a possibility that the initial share capital of a corporation may also be provided by more than one governmental organisations. But apart from that, the government may be one of its creditors. It can retain and re-use its funds according to the policy decided. Thus, a public corporation, within the limits prescribed by the relevant act, is quite an autonomous body and has a wide scope for adopting a system of incentives and punishment to ensure efficiency.

It can also happen that one government company or corporation becomes a holding company of another company either by

establishing it or by purchasing its share capital. Such an arrangement would obviously remove the so-held company farther away from direct intervention by the government.

Theoretically, we may distinguish between companies which are fully owned by the government and those which are partially owned but fully controlled by the government. The latter ones also, for all practical purposes may be termed public enterprises because the government can guide their working for the objectives that are laid down. Such controlled companies can be expected to adopt the price policies etc., which in the opinion of the government are in harmony with the public interest.

Some Issues

(A) *Objectives*. We have discussed the objectives of creating and expanding the public sector undertakings earlier and so the same need not be repeated here. It was noticed there that a varying set of objectives might be chosen for the public undertakings and that these objectives can be to some extent self-contradictory also. Here we can only add that the objectives chosen by the authorities should be, so far as possible, consistent with the overall objectives of economic, political and social values of the society. This is a very difficult task, but the one which cannot be lost sight of.

(B) *Cost-Benefit Analysis and Choice of Projects*. This question may be discussed with reference only to the new projects which are to be established. Since the public sector does not have unlimited resources at its disposal, it has to be selective in the choice of the projects so as to procure the best possible results for the society.[2] For each project, estimates of cost and benefits have to be made. Such a study is to show whether a particular project is worth the investment or not. It it is, then its worthwhileness has to be compared with the estimates made for alternative projects and only then the choice can be made. In this connection, the approach of the public authorities will basically differ from that of the private enterprises. A private enterprise would estimate the costs and returns in money terms and would try to find out whether commercially the project is profitable or not. But the public authority is expected to concern itself with the social costs and benefits. For a public enterprise, the cost would repre-

[2]For further discussion on this question see, United Nations Industrial Development Organisation (UNIDO), *Guidelines to Project Evaluation*; S. A. Marglin, *Public Investment Criteria*, R. Turvey (ed.), *Public Enterprises*, Penguin Modern Economics.

sent the alternatives foregone in which the community's resources could be employed and would also include the incidental and additional disadvantages which flow to the community. Similarly, the returns here would represent all the benefits, direct and indirect, which this project is expected to yield to the society. For quantifying the values of the benefits and costs, very often 'shadow prices' are used instead of the market prices. 'Shadow prices' are those hypothetical prices which are supposed to represent the real social valuation of the costs incurred and benefits received. Clearly, the choice of these shadow prices is subjective to a great extent. The technique of shadow prices is used to overcome two difficulties. The first is the fact that market prices are believed not to represent the social scale of values. The second one is that there are various items which have no market-value at all such as, life, health, social peace and the like.

Without going into too many technicalities, let us look at the way the cost-benefit analysis for a project may be undertaken We shall mention here two methods. The first one is to calculate the *discounted present value of the net benefits* and the second is to calculate the *internal rate of return*. Let us look at them turn by turn

An investment has many dimensions. Over its life time, right from the beginning, different costs are expected to be incurred. On the other hand, it is expected to yield benefits also. Such returns or benefits may begin only after the project is completed, but some indirect benefits can result even earlier. Anyway, for each period of the expected life of the project, the 'net benefit' is estimated. This net benefit is the benefits minus costs for that period. Symbolically, in any period, t, the net benefit would be equal to $(R_t—E_t)$ where R_t is the aggregate of direct and indirect benefits and E_t is the aggregate of direct and indirect costs for the pariod t, attributable to the project. This 'net benefit' then is discounted at a pre-determined rate of discount to get its discounted present value. Symbolically, if d is the present rate of discount, then the discounted present value (DPV) is given by

$$\text{DPV} = (R_0 - E_0) + \frac{R_1 - E_1}{(1+d)} + \frac{R_2 - E_2}{(1+d)^2} + \ldots + \frac{R_n - E_n}{(1+d)^n}$$

If it is already decided that a particular project is to be chosen, but its location, techniques of production etc. are to be decided out of various alternatives, then that combination of location and technique, etc. will be chosen for which the DPV is the maximum. But quite often, different projects compete for the same resources and the best projects (resources permitting) have to be chosen. For that we should relate the DPV to the cost of the project. In other words, we should

estimate for each project the benefit-cost ratio and choose those projects for which these ratios are the highest (subject to the condition that we have the resources to choose from those projects).

It would be seen that an important arbitrary variable here is the 'rate of discount' chosen for discounting the net benefits stream. This rate is supposed to represent the social time preference rate, the rate at which a society would care less for the future benefits and costs. Apart from the fact that in the absence of a sufficient knowledge, the choice of this rate would be arbitrary, there is no reason to maintain that this rate remains the same for all periods (which this method assumes).

Let us now consider the *second method*, namely, that of calculating *the internal rate of return*. Internal rate of return is that rate of discount by which the discounted present value of the stream of net benefits is reduced to zero. Symbolically, the internal rate of return is *RR*, if

$$\text{DPV}=O=(R_0-E_0)+\frac{R_1-E_1}{(1+RR)}+\frac{R_2-E_2}{(1+RR)^2}+\ldots+\frac{R_n-E_n}{(1+RR)^n}.$$

Here the project will be worthwhile if *RR* exceeds the rate of interest at which funds are obtained (or a social time preference rate for the funds to be invested in this project). This method makes the choice between different projects much easier because a project having a higher internal rate of return will obviously be better and should be chosen if resources permit. Furthermore, in the calculation of internal rate of return, the cost side of the project is automatically taken into account. This approach, however, creates difficulties if the negative values of some net benefits get interpersed with some positive values of net benefits. In that case the value of internal rate of return may not be uniquely determined.

(C) *Pricing Policy*. Pricing policy for public enterprises is a difficult task, the main reason being that the public enterprises are not necessarily for earning profit and pricing policy doesn't have to be uniform for all the public undertakings. A number of factors have to be taken into account before the pricing of a public undertaking is decided. The very first factor, as noted above, is the *objective or objectives* before the public undertakings. Like a private enterprise, it may aim at getting maximum profit, or it may have a policy of contributing to the distributive justice in the economy by reducing the inequalities of income and wealth. Similarly, it may have a specific purpose of encouraging the consumption of the services it is producing or the objective may be to fill in the supply gap of some essential inputs for other industries or to contribute to the building up

of the infrastructure of the economy for accelerating its economic growth. Apart from the objective or objectives which a public undertaking might be having before it, its pricing policy will be equally affected by the *opportunities* which it has in implementing this policy. Such opportunities are conditioned, amongst other things, by *three sets of circumstances.*

The first set is that of the *market structure.* If our public undertaking is one among many others operating in a competitive set up, then its price cannot effectively differ from the market price. If the private undertakings are acting in a kind of combination, then again any price which is significantly different from theirs will be thwarted by their action. On the other hand, if our public undertaking is the dominant one in the maket or is a monopoly, it is much easier to adopt a price of its choice in conformity with its objectives.

The second set of cirumstances concerns *its own working.* Ordinarily, it is assumed that in terms of organization and hence efficiency a public enterprise will be at par with private enterprises. but in reality it may not be so. Internal inefficiency of the enterprise can make the selection of an appropriate price policy difficult.

The third set of circumstances relates to the *sensitivity of the enterprise* to changing political and social demands. For effective results, the political and social atmosphere should be such as to let the public enterprise choose and adhere to its price policy consistent with its chosen objectives. Thus, depending upon the opportunities and changes therein, the pricing policy may or may not be in full conformity with its objectives.

Another factor relevant to the choice of price policy of a public undertaking will be *capacity to identify the beneficiaries* of the public service that it provides. If individual beneficiaries can be identified, only then can a public undertaking decide to levy a price for its services, otherwise not. It is, however, not maintained that a price will always be charged if the beneficiaries can be identified. If may still be decided to supply the services free of cost, as a matter of policy. Still another variable in the formation of price policy is the decision of the authorities as to whether the service so supplied would compulsorily form a part of consumption of the people or it would be left to their voluntary decisions. For example, street lighting, sanitation, eduation, and the like may be compulsorily made a part of the consumption of every eligible citizen or resident of a locality.

Dalton[3] mentions three principles by which the price policy of a public undertaking may be determined.

Firstly, there will be a category of public services which would be supplied free and which would be financed through the general public revenues. Dalton calls it the *general taxation principle*. In this category we may include such public undertakings as 'pure public goods' or those coming close to this description. The closer these goods to the pure public goods, the lesser will be the possibility of identifying the individual beneficiaries and charging them for the service. Furthermore, in some cases, some services may be supplied free as a matter of convenience and policy even when the beneficiaries can be identified. For example, the users of a road can be identified, but it may not be thought desirable to collect a fee from those who use the road. The cost of collection may be very high compared with the revenue collected. The system may cause a lot of inconvenience, delay and hardship and therefore a loss of welfare and efficiency to the society. All told, it may be thought better to finance the road out of general revenues or by collecting the funds indirectly through a tax on vehicles.

The *second* principle of determining the price would be the *compulsory cost of service principle*. Here the beneficiaries are identified, or at least they are supposed to be identified (and if need be, even the amount of service which each is consuming, is determined), and they are made to pay for the service. Provision of street lighting, for example, may be assumed to benefit the locality as a whole and the residents may be taxed on the basis of the household or the size of the family or some similar rule. It is possible, of course, that the rate of fee so levied may or may not be able to meet the full cost of the service and a part of it may be financed through general taxation.

The *third* principle of price determination would be the *voluntary price principle*. It is this principle which has attracted the maximum discussion. Here the consumers of the public service are free to choose the consumption of the public service by paying the price determined by the public undertaking. The question to be answered is: How should such a public undertaking fix its price? It should be remembered that the answer, amongst other things, will depend upon the considerations mentioned in the beginning of this Section, viz., the objectives and the opportunities. It is being assumed here that the beneficiaries of the service can be identified on an individual basis. For the sake of simplicity of argument, let it also be assumed that the public.

[3]Hugh Dalton, *Principles of Public Finance*, 4th ed., Chapter XIV.

enterprise in question is a monopoly and so is not constrained by the pricing policy of its competitors. If, therefore, it chooses to set a high price, it has no danger of being competed out from the market. Given these assumptions, let us consider, with Dalton, its policy with regard to the consumption of its product by the public.

If the consumption of such a service is believed to contribute to the welfare of the society, the policy would be to *encourage its consumption.* In general, therefore, the decision will be to set a low price in this case, possibly below the cost of production even. However, the choice of actual price will *also depend upon the elasticity of demand.*[4] For example, let us assume that the demand for the good in question is highly elastic. In such a case, a very low or zero price may bring about an excessive and wasteful consumption of the commodity. Under such circumstances, the problem has to be solved through some additional measures. For example, the supply of the good per individual or family up to a certain amount may be allowed free or at a very low rate and beyond that a higher rate may be charged. To illustrate, let us say that it is desirable that every family consumes 200 litres of water per person per day. So much water may be supplied at a nominal rate or even free and quantities of water consumed beyond that could be billed at rates at which water would be consumed only for genuine needs. Supplying water through unmetered connections, and charging for it at flat rates per household will only encourage a waste. It should be remembered that the demand for goods and services like water, medical care and the like has a very low elasticity of demand up to a certain extent. Assuming that this is socially a desirable consumption, it should be permitted, though excess consumption can be billed at higher rates. If on the other hand, the elasticity of demand is very low so that irrespective of the price, the amount of demand does not vary much, then the price can be kept very low or even zero since in that case the danger of wastage is not there.

If the policy is to discourage the consumption of the product or service being supplied by the public undertaking, then the policy should be to set a high price for the service. If the elasticity of demand is high, this would act as a strong deterrent against consumption of this item. Ordinarily, it should also be a source of profit to the authorities. But if it is found that the elasticity of demand for the product is so low that even a higher price would not reduce its

[4]For the role of elasticity of demand in pricing policy of public undertakings, see A. C. Pigou, *A Study of Public Finance*, 3rd ed., Chapter IV.

demand significantly, then additional measures also would have to be adopted. Fixing too high a price in this case might mean a loss of welfare to those who have to purchase the good (think of drug addicts), since they might have to reduce their expenditure on other useful items like the education of their childern, food and the like. In such a case, therefore, a reasonably high price coupled with some form of rationing would be helpful. Alternatively, there can be those goods (such as electricity for domestic use) whose consumption is sought to be restricted on grounds of inadequate supply, but not below certain standards. In these cases, again, the rates can be low up to specified quantities of consumption and may rise steeply beyond those limits.

The third category is of those goods whose consumption is to be neither encouraged nor discouraged as a matter of policy. In other words, the price itself is not to be used with the objective of regulating the consumption of the services. In this area, there has been a controversy as to whether the price should be equal or unequal to the marginal cost of production.[5] We must note that the marginal cost will be equal to the average cost only under conditions of constant returns. Under increasing returns, marginal cost will be less than the average cost and under diminishing returns, it will be higher than the average cost. Accordingly, if the price is set equal to the marginal cost, there will be a loss or abnormal profit according as the project is operating under increasing or diminishing returns.

It must be remembered, however, that it is not so easy to adopt marginal cost pricing. The very estimation of marginal cost poses conceptual and practical difficulties. For example, every project has certain fixed factors of production. Theoretically, in the long-run, all inputs are variable. In practice, however, once a plant is chosen, some inputs tend to become fixed. This causes a lack of correspondence between marginal cost and the average cost. Moreover, in usual theoretical analysis variable inputs are assumed to be perfectly divisible. This again is generally not true. If the inputs are lumpy, then there will be 'jumps' in the marginal cost figures. Thus take the case of a bridge or

[5]With the advent of welfare economics, the marginal cost pricing principle had created a good deal of controversy. A good review of that is contained in Nancy Riggles, "Recent Developments in the Theory of Marginal Cost Pricing," *Review of Economic Studies*, 1949-50, pp. 107-26. Also see M.J. Farrell, "In Defence of Public-Utility Price Theory," *Oxford Economic Papers*, NS, Vol. 10, 1958, pp. 109-23. Both these articles (the latter amended by the author) are reprinted in R. Turvey (ed.), *Public Enterprise*, Penguin Modern Economics.

a railway.[6] The marginal cost of one more vehicle or one more person using the bridge is very negligible. This is because most of the cost of having the bridge consists of the construction cost. Similarly, if a railway train can carry only *n* persons, but no more, then the marginal cost of carrying *n*th person will be nearly zero, but the marginal cost of carrying $(n+1)$ person will amount to running an additional train. Adhering strictly to the marginal cost principle will imply that every time the number of passengers exceeds a multiple of *n* by *one*, the passenger fare rate will have to be raised and then successively reduced as the number of passengers approaches another multiple of *n*. In other words, depending upon the number of passengers, the fare rate will have to be chosen out of a list of *n* fare rates. The problem becomes still more treacherous if we note that the passengers themselves are likely to change their demand for rail service in response to the revision of the rail fares.

Certain other limitations of the marginal cost pricing have been pointed out when the public undertaking is operating under increasing returns.[7] Thus, under increasing returns, when the price is equal to marginal cost, there will be a loss to the undertaking. Since the very policy is amounting to incurring a loss, it becomes difficult to impose efficiency criteria.

Public sector undertakings which might be subject to inefficiency for some other reasons, will have a tendency to encourage this inefficiency. It is also pointed out that the public undertakings are most likely to acquire funds at rates lower than the market rates because of the backing and creditworthiness of the government. Therefore, we find that the marginal cost would be representing a comparable marginal cost which an equally efficient private enterprise would face. Furthermore, unless it is specifically desired that the consumption of the product of this public undertaking is to be encouraged, the price should equal average cost and not marginal cost because no private enterprise, in comparable circumstances, would fix its price at that level and operate at a loss. Moreover, meeting this loss by the public authorities amounts to diverting of economy's resources from other uses into this one and this may not be desirable.

The above discussion shows that the task of determining the price of a service being supplied by a public undertaking is not an easy one. It has many dimensions and implications. There are also quite a few conceptual and practical problems. Questions of welfare and public

[6]Nancy Riggles, *op. cit.*

[7]Farrell, *op. cit.*

policy also crop in. Public undertaking may have a number of objectives before them which have to be reconciled with the pricing policy. Above all, there is the crucial problem of efficiency in public undertakings. Whatever be the price policy on paper, its true objective is likely to suffer if the undertaking is not working efficiently. In such a case, there will be a wastage of the productive resources of the society; the cost of production will be high and for a given price the project will tend to run into a loss or erode its profit, which in turn will have some consequent effects. It follows, further, that the fact that a public enterprise is making a profit is not necessarily an indication of its efficiency The enterprise might be making use of its monopoly power and earning a profit by charging a high price, or it might be getting inputs at controlled or subsidized prices. Unless, therefore, the prices of the product and the inputs reflect the relative scarcity of resources being employed by the enterprise, profit as such cannot be indicative of the level of efficiency.

(D) *Management, Accountability and Incentives.* In a number of underdeveloped countries, the governments have nationalised private enterprises or started new public enterprises at a rapid rate, often in disregard to their own administrative and other capabilities. Public undertakings are liable to face peculiar problems of their own, and more so when their growth is at a fast rate. Let us consider the problems of management, accountability and incentives in these undertakings. These problems are interrelated and affect one another.

Take the case of accountability first. Accountability refers to the fact that the management is answerable to the authorities for its omissions and commissions, and its performance is to be judged by the authorities. The authorities are to have some basis of evaluating the efficiency of the enterprise. In the case of private enterprise, the problem is simple. There the criterion of efficiency is profit. The management is expected to realize sufficient profit for the undertaking and its failure to do so labels it as inefficient. In the case of public undertakings, however, the profit criterion as a measuring rod cannot be applied straight away in every case. Let us first consider the case of departmental undertakings. Here an undertaking is seldom having enough of initiative. The employees are government employees and at least those on the top are liable to transfer and the like. The whole set up works under definite and rigid rules and regulations wherein the financial controls are particularly tight ones. Generally, even the financial transactions of departmental undertakings might be counted as a part of the budgetary transactions of the government. The employees enjoy a security of service like other government employees.

There is seldom a scope for initiative or an incentive for taking one. If an employee is technically right, he cannot be punished for the obvious mistakes he might be making. In this way, the accountability of the undertaking to the government of the country and through it to the legislature amounts only to safeguards against possible technical errors (violating rules and regulations), but not more than that. Managerial efficiency is not found as a part of the system; it depends more upon the type of individuals who are manning the undertakings.

When it comes to government companies or statutory corporations, we find that there is a greater autonomy enjoyed by such institutions. Their accountability runs more in terms of fulfilling the objectives with which they were started and in terms of conducting their operations within the legal, institutional and financial discipline of the country. The legislature exercises an indirect control over them—by discussing their policies, performance and failures.

Both these undertakings are also saddled with peculiar problems because of which their performance remains below the mark. The first hurdle they face is generally the lack of clarity regarding their objectives. A private enterprise is expected to make a profit and the management knows that its performance is to be judged by that. Its achievements in the field of production, research, marketing and so on are all subservient to the earning of current profits or providing a base for the future ones. But a public undertaking has seldom a clearly defined objective before it. It might simultaneously be expected to aid the economy in achieving a more rapid rate of economic growth by contributing a surplus (in the commercial sense), by proving a base for other industries, or by filling a supply gap. It might be expected to help the society in its efforts to move closer to an egalitarian set up and the like. Some of these objectives may be in conflict with each other, at least in the short run. It may not be within the capacity of an undertaking to achieve all these objectives in an efficient manner. The difficulty will be greater if the undertaking is hauled up and held accountable in terms of different objectives at different times. Such a confusion helps the management to camouflage its inefficieney and performance. Losses are explained away as due to the pursuance of various social objectives, which incidentally in some cases are intangible and cannot be measured. High prices, necessitated on account of inefficiency and high costs, may be justified on account of 'fair rate of return' on the capital invested, and on grounds of 'rationalising' the rates. Various circumstances 'beyond the control of the management,' delays in supply of raw materials and other inputs and the like are quite favourite excuses behind which protection is sought.

Another limitation under which a public undertaking has to generally work is the service conditions of its employees. Not much scope is left for the management to introduce an adequate system of incentives and punishment for initiative and achievements on the one hand and errors, lethargy and negligence on the other. The fact that the top managerical personnel may often be appointed out of a common administrative pool and may be subject to transfer, or the fact that some appointments may be made on considerations other than competence, adds to this general malaise wherein inefficiency is protected and efficiency goes unrewarded. The subordinates have to be guaranteed a security of service and rules for promotion, etc. have to be made more and more mechanical in order to protect the employees from the personal whims of the managerial staff. But such an approach cuts at the roots of organisational efficiency. The workers find inadequate incentives for honest and hard work and not much danger of punishment if duty is not taken seriously. Militant trade unions thrive in this atmosphere with the main objective of securing more rights for their members with less duties, if possible. In this way, the whole set up becomes a victim of a vicious circle where inefficiency feeds upon itself.

Such a type of vicious circle of inefficiency may set in right at the planning stage of the enterprise which is mostly at some departmental level. Inordinate delays in drawing up, scrutinizing, revising and approving the plans start pushing up the cost of the project right from the beginning. In order to avoid this vicious circle, it is important that the government keeps in mind the limitations under which the public undertakings will be working and the objectives which are to be achieved. Before embarking upon any project the authorities must assess the administrative resources that can be put at the disposal of the undertaking. The objective or objectives should be clearly laid down and, if possible, their relative weightage determined beforehand. Both the workers and the management must be made to know the objectives for which the undertaking has been set up. There should be sufficient operational and administrative autonomy for the enterprise and it should be held collectively and firmly responsible for the achievement for the desired results. To this end, the enterprises should be manned by the personnel appointed on grounds of merits and competence, and should be given the necessary financial operatianal and administrative autonomy within the legal framework of the country. The governmental control over the financial matters should be limited to commercial type of auditing and not scrutinizing and approving each financial item and then emphasising even insignificant deviations between the approvals and actuals.

PART 2

INDIAN PUBLIC FINANCE

17 INDIAN FEDERAL FINANCE—I

HISTORICAL BACKGROUND

Indian federal structure is the result of gradual evolution from a centralized authority.[1] Indian Empire under the British rule was divided into two parts—the Provinces which were directly administered by the Government of India and the Provincial Governments, and the Princely States which had internal financial autonomy. Till Independence, the history of Indian fiscal federalism is the history of the decentralisation of financial powers from the Central Government to the Provincial Governments. Until 1871, the Provincial Governments had no independent sources of revenue and they received fixed grants from the Central Government to meet their public expenditure. By its very nature, such a system did not force the Provinces to observe enough of financial discipline and avoid wastage. This was more so since any improvement in the economy of a Province would not benefit its government in terms of greater revenue accrual. The first step by which the Provinces were given some heads of revenue was taken in 1871 when income from certain heads like registration, police, jails, medicine, education, roads and civil works was handed over to the Provinces. But because of obvious inadequacy of these revenues the system of lump sum grants still continued. This system remained in force till 1904 with some modifications from time to time by which the Provinces acquired some additional heads of both revenue and expenditure.

It was only in 1904 that a system of *divided heads* of revenue was adopted on a quasi-permanent basis and was made permanent in 1912. In this scheme, some taxes like land revenue, irrigation, excise duties and stamp duties were shared between the Centre and the Provinces. Some other taxes, however, were fully retained by the Centre, such as income from posts and telegraphs, railways, salt, opium and mint. This system of divided heads was still accompanied with that of grants from the Centre to the Provinces.

This movement towards decentralisation was further consolidated under the Montague-Chelmsford Reforms which took practical shape in the form of Government of India Act, 1919. (It came into force in 1921.) This Act was basically designed to let the Indians have some

voice in the government of the country. And accordingly, various matters of regional and local importance went to the Provincial Goverments, such as, education, public health, local self government and the like. But matters of national importance like defence, currency and mint, and foreign affairs were left with the Central Government.

This scheme, however, lacked a close correspondence between the functions and resources assigned to the Provincial Governments. The resources given to them were relatively inelastic and inadequate while the functions assigned to them were of expanding nature. Their resources included land revenue, irrigation receipts, excise duties, judicial stamps, forests and registration, while all the remaining resources like income tax, salt and opium revenue, customs, contribution from the railways and posts and telegraphs, and currency and mint were with the Central Government Strangely enough, at the time of introducing the reforms, it was felt that the Provinces would be having more revenue than their needs and that they would have to contribute to the Central Government's budget for closing its deficits. One reason for the currency of this idea was that land revenue had been assigned to the Provinces and this was the most important source of revenue at that time (about 17% of the country's total revenue).

The Meston Award

It was under this idea that the Financial Relations Committee (under Lord Meston) was constituted to recommend a scheme of Provincial contribution to the Central Government. This committee suggested a scheme which was based upon what it called the 'initial contributions' and 'standard contributions.' The Meston Award maintained that the Provinces would acquire larger revenues on account of the abolition of the scheme of the divided heads and on account of their share in the income tax (which it was recommending additionally). They were, therefore, expected to be able to make contributions to the Central Government out of their surplus revenue receipts, starting from the lower 'initial contributions' in 1921-22 and rising up to the 'standard contributions' in seven years. The standard contribution, of course, was to be determined separately for each Province on the basis of several factors relevant to the determination of the financial conditions of the Province. Amongst other things, it was not realized that the Provinces had an unevenly developed source of agricultural revenue. While agriculture in some Provinces was backward, in others, land revenue was inelastic due to

Permanent Settlement. Therefore, as expected, there was a strong opposition to the scheme of contributions from the Provinces and accordingly the Joint Select Committee of the British Parliament on Draft Rules recommended that the Provincial contributions should be gradually abolished. The share of the Provinces in income tax was fixed at three pies in a rupee (that is 1/64th of the amount) by which the assessed income in any year exceeded that of the year 1920-21. This recommendation was incorporated in the devolution Rules 14 and 15 under the Government of India Act, 1919.

The actual financial developments in the subsequent years showed that the budgetary position of the Central Government did in fact improve as compared with that of the Provinces. This facilitated the task of reducing the Provincial contributions and by 1928-29 they were totally abolished. The depression of the 1930's weakened the revenue position of the Provinces and they had to be helped by the Central Government with the result that in 1934-35 the Central Government made a provision for helping the Provinces and at the same time agreed to assign 50% of the net proceeds of the export duty on jute to the jute growing Provinces of Assam, Bengal, Orissa, and Bihar. In the Central Budget for 1935-36 and 1936-37, all the Provinces were given grants for various purposes.

The Government of India Act, 1935

The experience of the Government of India Act, 1919 let the British Government further in the direction of Provincial autonomy in the matters of resources and this resulted in the Government of India Act, 1935 which came into force in 1937. In this Act, the functions of the Central and Provincial Governments were classified such that the Provincial Legislative List contained 94 entries, the Federal Legislative List contained 59 entries and a third list contained the concurrent legislative powers and had 36 entries. In the same way, the financial resources were also divided into three categories, namely: (*a*) Federal, (*b*) Provincial, and (*c*) Jointly Federal and Provincial.

The third list covered those taxes and duties which could be levied only by the Central Government but the revenues from which were to be shared between the Central and the Provincial Governments. The Government of India Act, 1935, laid a firmer foundation for financial federalism, the structure of which was to form the main basis for the financial federalism after Independence.

Firstly, as noted above, it provided for tax-sharing. Section 138(1) of the Act laid down that taxes on income other than agricultural income would be levied and collected by the Central Government,

but a prescribed percentage of the net proceeds (after deducting the cost of collection and the amounts attributable to the Chief Commissioners' Provinces) would be assigned to the Provinces. The exact percentage, however, was left to be determined later. Furthermore, as in the Constitution, the Federal Government was empowered to levy a surcharge for the purposes of the Federation only. The jute growing Provinces led by Bengal had been pressing for a share in export duty on jute and jute products, pleading that such an export duty was reducing the scope for Provincial taxation. This plea was accepted vide Section 140(2) of the Act, which provided that 50% or more of the net proceeds of the export duty on jute and jute products be assigned to the jute growing Provinces.

Similarly, Section 140 provided for tax-sharing not on obligatory but enabling basis. The Act also provided for certain taxes which were to be levied and collected by the Central Government and whose entire net proceeds were to be assigned to the Provinces. Here again, of course, the Central Government was to retain the share attributable to the Chief Commissioners' Provinces. These taxes included taxes on goods and passengers carried by railways and air, taxes on railway freights and fares, duties on succession of properties other than agricultural land, and stamp duties.

The *second* important feature of this system was the provision of grants-in-aid from the Central Government to the Provinces. Under Section 142 the Central Government could make conditional and discretionary grants to the Provinces and these could be of different amounts for different Provinces in the light of their requirements. At the same time Section 150(2) enabled both the Central and Provincial Governments to make grants for any public purpose.

It would be noted that this Act contemplated a financially strong Centre and not the one which would be dependent upon the contribution from the Provinces. Even otherwise, it was stipulated that in the event of both the Central and a Provincial Government legislating on a subject in the concurrent list, the federal law would prevail.

Niemeyer Award

To give practical shape to the above mentioned provisions of the federal financial adjustments, Sir Otto Niemeyer was asked to make a report and recommend on matters connected with Sections 138(1), 138(2), 140(2) and 142 of the Government of India Act, 1935.[1] Sir Niemeyer recommended that 62½% (according to the Act they could

[1]Sir Otto Niemeyer, *Indian Financial Enquiry Report*, 1936.

be 50% or more) of the net proceeds of jute export duty should be assigned to the Provinces of Bengal, Bihar, Assam and Orissa. Regarding the sharing of income tax, he had to deal with two questions. The first was the determination of the percentage of the net proceeds which were to be assigned to the Provinces and the second was the distribution of this amount between the Provinces themselves.

Keeping in view the necessity to ensure financial stability of the Central Government and the needs of the Provinces, Sir Niemeyer recommended that 50% of the net proceeds of income tax should go to the Provinces. Regarding the distribution of the tax share as between the Provinces he concluded "that substantial justice should be done by fixing the scale of distribution partly on residence and partly on population."[2] He further asserted that from a practical administrative standpoint it was essential to base the distribution on a fixed percentage which would not change from year to year.

On these considerations, he recommended that the percentage share, in the divisible pool, of different Provinces be as under:

Madras 15; Bombay 20; Bengal 20; United Provinces 15; Punjab 8; Bihar 10; Central Provinces 5; Assam 2; North-West Frontier Province 1; Orissa 2; and Sind 2.

As regards the grants from the Central Government to the Provincial Governments under Section 142, Sir Otto Niemeyer, after taking into account various factors bearing upon the needs and resources of the Provinces recommended the following grants:[3]

These grants, in fact, increased with the passage of time. Section 150 under which the Federal Government (or a Provincial Government) could make a grant for any public purpose was used in the wake of various developments in the country like food shortage,

Province	*Grant per annum (Rs in lakhs)*	*Remarks*
United Province	25	For a fixed period of 5 years.
Assam	30	Subject to the proposal that Assam Government would bear Rs 5 lakhs towards the cost of Assam Rifles.
North-West Frontier Province	100	Subject to reconsideration at the end of five years.
Orissa	40	With 7 lakhs additional in the first year, and 3 lakhs additional in each of the next four years.
Sind	105	For 10 years with 5 lakhs additional in the first year, then falling gradually until grant ceases entirely in 45 years.

[2] *Ibid.*, para 34.
[3] *Ibid.*, para 24.

defence requirements and relief and rehabilitation of refugees especially after Independence.

Deshmukh Award

Indian Constitution came into force in 1950 and it provided for a Finance Commission for recommending the principles governing the sharing of divisible taxes and grants-in-aid. But in the meantime transitory provisions had to be made. Accordingly, C.D. Deshmukh was appointed to examine the question and make recommendations. He stuck to the basic principles as laid down by Niemeyer Award. However, because of Partition, 14.5% of the share of income tax proceeds meant for the Provinces had been released. That is to say, the share going to Sind, North-West Frontier Province, and parts of Punjab and Bengal was now available for redivision between other States. An *ad hoc* arrangement had been made in the meanwhile. Deshmukh Award made some marginal changes in this, in the light of population and needs of the States. The percentage share going to each State out of the total meant for the States, as determined under the *ad hoc* arrangement and as under Deshmukh Award is shown in Table 17.1.

Since most of the jute growing areas had gone to Pakistan after Partition, compensatory grants were given, pending the recommendations of the Finance Commission, in lieu of the share in jute export duty to the jute growing States of Assam, West Bengal, Orissa and Bihar. On the basis of Deshmukh Award, West Bengal got Rs 105 lakhs per annum, Assam got Rs 40 lakhs per annum, Bihar was

TABLE 17.1

PERCENTAGE SHARES OF INDIVIDUAL STATES IN THE INCOME TAX PROCEEDS ASSIGNED TO THE STATES

State	*Ad hoc Arrangement*	*Deshmukh Award*
Madras	18.0	17.5
Bombay	21.0	21 0
West Bengal	12.0	13.5
UP	19.0	18.0
Punjab	5.0	5 5
Bihar	13.0	12.5
MP	6 0	6.0
Assam	3.0	3.0
Orissa	3.0	3.0
Total	100.0	100.0

given Rs 35 lakhs per annum and Orissa was given Rs 5 lakhs per annum.

Meanwhile financial integration of erstwhile Princely States was also in progress. They were either being merged into bigger units and called Part B States, or they were being merged into their neighbouring Part A States (erstwhile British Provinces). It was decided to bring the tax and expenditure structure of these erstwhile Princely States in conformity with rest of India. In the process, therefore,

TABLE 17.2

RESOURCES TRANSFERRED FROM THE CENTRAL GOVERNMENT TO STATES PROVINCES DURING 1937-38 TO 1950-51

(Rs in lakhs)

Year	*Share of Income Tax*	*Jute Export Duty*	*Subversions under Niemeyer Award*	*Grants under Articles 273, 274 and 278*	*GMF, Post-war Development Rehabilitation etc. Grants*	*Total*
1937-38	125	265	312	–	—	702
	(17 8)	(37.7)	(44.5)			(100.0)
1938-39	150	251	303	—	—	704
	(21.3)	(35.6)	(43.1)			(100 0)
1939-40	279	256	303	—	—	838
	(33.3)	(30.5)	(36.2)			(100.0)
1940-41	416	185	303	—	—	904
	(46.0)	(20.5)	(33.5)			(100.0)
1941-42	739	195	303	—	—	1237
	(59.9)	(15.7)	(24.4)			(100.0)
1942-43	1090	140	275	—	—	1505
	(72 4)	(9.3)	(18.3)			(100 0)
1943-44	1950	138	275	—	300	2663
	(73.2)	(5 2)	(10.3)		(11.3)	(100 0)
1944 45	2665	149	170	—	702	3677
	(72.2)	(4.1)	(4 6)		(19.1)	(100 0)
1945-46	2875	157	170	—	802	4004
	(71.8)	(3 9)	(4.2)		(20 1)	(100 0)
1946-47	2987·	287	170	—	1717	5161
	(57.9)	(5 6)	(3 3)		(33.2)	(100.0)
1948-49	4179	143	70	--	2912	7304
	(57.1)	(2.0)	(1.0)		(39 9)	(100 0)
1949-50	4574	194	70	186	2850	7874
	(58.1)	(2.5)	(0.9)	(2.4)	(36 2)	(100.0)
1950-51	4752	—	—	1483	1211	7446
	(63.8)			(19.9)	(16.3)	(100 0)

Source: D.T. Lakdawala, *Union-State Financial Relations* (1967).

Note: Figures in brackets are percentages of the total for the year.

these Part B States lost a few heads of revenue and expenditure and most of them developed revenue gaps for which compensatory grants were given to them on a transitional basis. Similarly, Part A States whose finances had got disturbed on account of the merger of some of the Princely States with them got compensatory grants on transitional basis.

Table 17.2 gives a brief idea of the resources transferred from the Central to the State/Provincial Governments from the commencement of the Government of India Act, 1935 in 1937-38 to 1950-51.

FINANCIAL FEDERALISM UNDER CONSTITUTION

The Constitution of India came into force in 1950. It follows more or less the pattern laid down in the Government of India Act of 1935. It divides the functions and financial powers of the government into Central and State spheres together with the concurrent areas. It also provides for sharing of taxes in various forms and a system of grants-in-aid. The approach in general has been to give due regard to efficiency at both administrative and financial levels. The Centre has been assigned those resources which have national or inter-State base and the same has been the approach with regard to division of functions also.

The Seventh Schedule of the Constitution of India lays down the respective functions and financial resources for the Centre and the States. It contains three Lists. The Union List consists of 97 entries and contains the following sources of tax revenue for the Central Government:

(1) Taxes on income other than agricultural income (entry 82);

(2) Duties on customs including export duties (entry 83);

(3) Duties of excise on tobacco and other goods manufactured or produced in India except (*a*) alcoholic liquors for human consumption, and (*b*) opium, Indian hemp and other narcotic drugs and narcotics, but including medicinal and toilet preparations containing alcohol or any substance included in this sub-paragraph (entry 84);

(4) Corporation tax (entry 85).

(5) Taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; taxes on the capital of companies (entry 86);

(6) Estate duty in respect of property other than agricultural land (entry 87);

(7) Duties in respect of succession to property other than agricultural land (entry 88);

(8) Terminal taxes on goods or passengers carried by railway, sea or air; taxes on railway fares and freights (entry 89);

(9) Taxes other than stamp duties on transactions in stock exchanges and future markets (entry 90);

(10) Rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts (entry 91);

(11) Taxes on sale or purchase of newspapers and on advertisements published therein (entry 92);

(12) Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce (entry 92-A),

(13) Fees in respect of any of the matters in the List, but not including fees taken in any court (entry 96),

(14) Fees taken in Supreme Court (entry 77).

The *non-tax* resources for the Union Government include the following

(1) *Borrowings, both internal and external*. Under Article 292 of the Constitution, the Government of India can borrow on the security of the Consolidated Fund of India, subject to any limit which Parliament may lay down.

(2) *Income from various government undertakings and monopolies.* These include income from currency and mint, Reserve Bank of India, railways, posts and telegraphs and other commercial and non-commercial undertakings.

(3) Income accruing to the Government of India on account of the exercise of its sovereign rights and performance of functions connected with or arising out of these rights. This would include, for example, income from government property, income or property accruing from lapse or escheat, war indemnities, and so on.

List II of the Seventh Schedule covers the functions and the financial resources of the States. This List has 66 entries and contains the following sources of tax revenue for the State Governments:

(1) Land revenue (entry 45);

(2) Taxes on agricultural income (entry 46);

(3) Duties in respect of succession to agricultural land (entry 47);

(4) Estate duty in respect of agricultural land (entry 48);

(5) Taxes on lands and buildings (entry 49);

(6) Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development (entry 50);

(7) Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower

rates on similar goods manufactured or produced elsewhere in India: (*a*) alcoholic liquors for human consumption, and (*b*) opium, Indian hemp and other narcotic drugs and narcotics, but not including medicinal and toilet preparations containing alcohol or any substance including in this sub-paragraph (entry 51);

(8) Taxes on the entry of goods into a local area for consumption, use or sale therein (entry 52);

(9) Taxes on the consumption and sale of electricity (entry 53):

(10) Taxes on the sale or purchase of goods other than newspapers excluding inter-State sale (entry 54);

(11) Taxes on advertisements other than advertisements published in the newspapers (entry 55);

(12) Taxes on goods and passengers carried by road or on inland waterways (entry 56);

(13) Taxes on vehicles for use on roads (entry 57);

(14) Taxes on animals and boats (entry 58);

(15) Tolls (entry 59);

(16) Taxes on professions, trades, callings and employments (entry 60);

(17) Capitation taxes (entry 61):

(18) Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling (entry 62);

(19) Rates of stamp duty in respect of documents other than those subject to stamp duty by the Government of India (entry 63);

(20) Fees in respect of any of the matters in the State List, but excluding court fees (entry 66);

(21) Fees taken in all courts except Supreme Court (entry 3).

(22) Share in some specified Union taxes.

The *non-tax* revenues of the States include the following:

(1) The State Governments are authorized to borrow under Article 293, but only within the country, including loans from the Government of India. A State legislature may impose an upper limit upon the total borrowings by that State. Furthermore, if any State is under debt to the Government of India, or if any debt guaranteed by the Government of India is still not fully paid, then in that case the State Government can borrow further only with the permission of the Central Government and subject to any conditions which the Central Government may impose.

(2) Income from government undertakings owned fully or partly by the State Government.

(3) Income from public property owned by the State Government.

(4) Royalty from mines, forests, treasure-trove etc.

(5) Grants-in-aid from the Central Government.

(6) Other grants from the Central Government.

There are certain *specific restrictions* on the Central and State Governments on levying taxes. For example, property belonging to a State Government cannot be taxed by the Union Government and vice versa. Subject to this condition, however, *all residual powers rest with the Government of India.* It would also be noted that some taxing powers with respect to similar subjects have been divided between the Centre and the States. Thus, the Central Government can tax the non-agricultural income but the power to tax agricultural income lies with the States. Similarly the Centre can impose estate and succession duties only on properties other than agricultural lands. Excise duties have been similarly divided. The State Governments can levy excise duties only on liquors, narcotics and drugs—the remaining items are reserved for the Centre. The States can tax advertisements, but not those appearing in newspapers Similarly they are allowed to tax goods and passengers carried by road or inland waterways, but air, sea and rail traffic is for the Union Government to tax.

The Actual Levying, Collection and Appropriation of Tax Proceeds

The actual levying and collection of taxes, however, follows the dictates of administrative and financial efficiency, while the allocation of proceeds follows, as we shall see, the relative needs of various governments. On this basis, the tax revenue of the country as a whole may be divided into the following five categories:

(A) *The first category* is of those taxes which are levied, collected and retained by the Central Government. All the taxes mentioned in the Union List with the following exceptions belong to this category:

(*i*) income tax *has to be* shared with the State Governments under Article 270;

(*ii*) under Article 272, the Central Government is *permitted* to share the Union Excise Duties with the States; and

(*iii*) taxes mentioned in category B below are wholly assigned to the States.

(B) *The second category* consists of those taxes which are levied and collected by the Central Government but are wholly assigned to the States. Article 269 lists the following taxes in this category, namely:

(*i*) duties in respect of succession to property other than agricultural land;

(*ii*) estate duty in respect of property other than agricultural land;

(*iii*) terminal taxes on goods and passengers carried by railways, sea or air;

(*iv*) taxes on railway fares and freights;

(*v*) taxes other than stamp duties on transactions in stock-exchanges and future markets;

(*vi*) taxes on the sale or purchase of newspapers and on advertisements published therein;

(*vii*) taxes on the sale or purchase of goods other than newspapers where such sale or purchase takes place in the course of inter-State trade or commerce.

The States can also vacate certain tax fields in favour of the Centre The Centre would then collect these taxes and transfer back their proceeds to the States as recommended by the Finance Commission. Currently, the Centre is levying Additional Duties of Excise in lieu of Sales Tax on tobacco, sugar and textiles. These duties are in the nature of tax rental arrangements and their net proceeds are wholly assigned to the States.

(C) *The third category* is of those taxes which are levied and collected by the Union Government but which are shared with the States either on a mandatory or permissive basis. As seen above, income tax and Union Excise duties come in this category. A surcharge on income tax, however, is not shared with the States.

(D) *In the fourth category* are those taxes which are levied by the Union but collected and retained by the States. The underlying idea here is to ensure uniformity of taxes which are of inter-State importance. According to Article 268, this category consists of stamp duties and excise duties on medicinal and toilet preparations.

(E) *The last category* is of those taxes which are levied, collected and retained by the States.

It would be seen that our Constitution leads to a strong imbalanced division of resources in favour of the Government of India. The needs of the States have increased far more rapidly on account of increasing governmental responsibilities in all walks of life of the country; but their revenue resources are such as do not exhibit a sufficient buoyancy along with the growth of economy, except probably sales tax. Furthermore, the system of grants-in-aid of revenue, which is discriminatory and related to the 'needs' of the States, is not helpful in leading the States to make fuller efforts at securing revenue resources. Such an effort would reduce the 'need' of the State Government under consideration and in practice some States could not get grants for precisely the reason that they did not need them. The system of grants-in-aid, therefore, while essential for

helping the States in need and for removing regional imbalances, also has a disadvantage. It acts as a check on the States' efforts to raise revenue. The States' reluctance to impose agricultural income tax, for example, is partly explained by this factor. Similarly, the States have not been able to properly rationalize the rates for irrigation water and the like. Anyway, in view of the recognized inadequacy of the revenue resources of the States, the Constitution provides for a mechanism of transfer of resources from the Centre to the States, in the form of tax sharing, grants-in-aid and loans.

Mechanism of Resource Transfers

(A) *Tax-sharing.* Let us first take up the question of tax-sharing. We have seen above that income tax has to be shared between the Centre and the States, but any surcharge levied on income tax for the purposes of the Union is not to be shared. Corporation tax is also fully retained by the Centre. The proportions in which the net proceeds of income tax are shared between the Centre and the States on the one hand, and as between the States on the other, are determined on the recommendations of the Finance Commission. Union excise duties are shared on a permissive basis. Sharing of these duties started with only three commodities with the First Finance Commission, but now all the Union excise duties are shared by the Centre with the States. The actual percentage going to the States is also decided on the recommendations of the Finance Commission.

The Government of India started imposing Additional Duties of Excise under the Additional Duties of Excise (Goods of Special Importance) Act, 1957 on certain commodities In 1956, the National Development Council took a decision in favour of levying of these additional duties in lieu of sales tax in the interest of convenience to trade and avoidance of tax evasion. But it should be noted that the Government of India started imposing regulatory duties under Section 12 of the Finance Act of 1971 on certain commodities like steel, iron and steel products, copper, zinc, aluminium and unmanufactured tobacco. These regulatory duties of excise were replaced by auxiliary duties in 1973 and these duties were meant for the purpose of the Union only. The Sixth Finance Commission, however, recommended that from 1976-77 onwards these auxiliary duties should also be brought in the divisible pool. Consequently, the Centre levied in 1978-79 a 'special duty of excise' at the rate of 5% of the basic duty on all goods subjected to basic duties. The proceeds of this special duty are not shared with States.

Sharing income tax and excise duties with the Centre has enabled

the States to benefit from the buoyancy of the tax system with the growth of the economy. Along with this, as noted above, the States have also the sales tax which is expected to show a buoyancy along with the growth of economic activities and expansion of trade and commerce. However, the States believe that the corporation tax should also form a part of the income tax proceeds, especially since the relative importance of corporation tax has been increasing. Thus while in 1950-51 the yield from corporation tax was only Rs 41 crores as against Rs 133 crores from income tax, the budget estimates for 1980-81 place corporation tax at Rs 1,504 crores as against Rs 1,426 crores of income tax.

(B) *Grants-in-aid.* The second instrument provided by the Constitution for bringing in financial balance between the Centre and the States is that of grants-in-aid of revenues of the States. Sharing of tax revenues, by definition, cannot ensure vertical financial balance between the Centre and the States. In addition, there is generally the need to reduce regional imbalance also, which tax-sharing as such cannot accomplish. The grants-in-aid of the revenues of the States, therefore, have to be discriminatory and need not be of the same amount for each State. In Indian financial set up grants are currently given under Articles 275 and 282. Article 273 is no longer in use. It stipulated that the Government of India should give grants-in-aid to West Bengal, Bihar, Assam and Orissa in lieu of assignment of share of the net proceeds of export duty on jute and jute products. These grants were to be given to these States for a period of 10 years from the commencement of the Constitution or for the duration for which the export duty was levied, whichever was earlier Under Article 275 the Centre gives grants to States on the recommendations of the Finance Commission for meeting their revenue gaps and for the welfare of tribal areas. Article 282, on the other hand, allows the Central and State Governments to make discretionary grants for any public purpose they choose. This Article has been used extensively for giving Plan and other grants (such as for drought and flood relief) by the Centre to the States.

(C) *Loans.* The third instrument for financial adjustment is that of loans. The loans from the Central to the State Governments are given for various purposes, both developmental and non-developmental, as also for Plan and non-Plan schemes. The States have become heavily indebted to the Centre. This raises certain issues which we shall discuss in a later chapter.

18 INDIAN FEDERAL FINANCE—II

THE FINANCE COMMISSION

The Finance Commission is a salient feature of the Indian Constitution. Under Article 280, a Finance Commission was to be appointed within two years of the commencement of the Constitution. The Article further lays down that the President has to appoint a Finance Commission every five years or, if need arises, earlier. In pursuance of this Article, the Finance Commission (Miscellaneous Provisions) Act, 1951 was passed. The task of the Finance Commission as laid down in the Constitution is to make recommendations to the President as to cover the principles governing the distribution of the tax proceeds between the Centre and the States as also between the States. It is similarly to recommend the principles on the basis of which the Central Government is to give grants to the States in aid of their revenues (but not the discretionary grants under Article 282) and any other matter which may be referred to it. Regarding even statutory grants under Article 275, to be made to the States in aid of their revenues, the Finance Commission will make recommendations only if the President is satisfied that one or more States are in need of such grants and this task is included in their terms of reference. The transfer of resources to the States, once the Finance Commission has been constituted, can be made only after the recommendations of the Commission have been considered (which for all practical purposes means accepting the recommendations of the Commission).

The institution of Finance Commission provides a much needed flexibility in the interest of optimum distribution of national resources as between different governments in the country in accordance with their respective needs. No fixed distribution of resources is likely to satisfy the demands of the situation for all times to come, especially in a developing economy where a good deal of regional inequalities exist. The institution of Finance Commission admits of a periodical review of the situation and a proper adjustment if and when it is needed. These comments, however, do not imply that the actual solutions as arrived at by the Finance Commission would always be the ideal ones. It would be noted that the Finance Commission can-

make recommendations for the transfer of resources only with respect to the sharing of taxes and with respect to statutory grants-in-aid of revenues of the States. Some *discretionary grants* which have assumed a great deal of importance can be made under Article 275 (1) (relating to the development and welfare of the tribal areas) but have been specifically kept out of the terms of reference of the Commission. Secondly, the system of statutory grants is directed towards meeting the "revenue needs" of the State Governments, and this induces them not to make as much effort at resource mobilisation as they can otherwise.

In all, seven Finance Commissions have been appointed till now, and all of them have also submitted their reports. The First Finance Commission was appointed in November 1951 and submitted its report at the end of December 1952. The Second Commission was appointed on 1 June 1956 and submitted its report in September 1957. The Third Commission was constituted in December 1960 and submitted its report in December 1961. The constitution of the Fourth Commission took place in May 1964 and the report was submitted in August 1965. The Fifth Commission was constituted in February 1968 and the report came in July 1969. The Sixth Commission was constituted on 28 June 1972 and its report covers the period 1974-75 to 1978-79. The report of the Seventh Finance Commission was submitted in October 1978 and covers the period 1979-80 to 1983-84.

THE FINANCE COMMISSION AND TAX SHARING

Income Tax

Income tax is the only tax which is compulsorily shareable between the Centre and the States. But the Constitution specifically lays down that the Corporation tax and any Union surcharge on income tax will not be shared with the States. The States believe that they have been deprived of their legitimate share in an expanding source of revenue by the exclusion of Corporation tax from the divisible pool especially because yield from Corporation tax has been increasing at a rate much faster than the yield from income tax. They are also against the exclusion of the Union emoluments for the purpose of determination of the divisible pool. Actually, they feel all the more aggrieved on account of the Finance Act of 1959 whereby a part of tax paid by companies got classified as corporation tax (instead of as income tax) and was excluded from the divisible pool. Thus, successive Finance Commissions have been facing three recurring questions and representations:

(1) The States have been pressing for the inclusion of the corporation tax and the Union emoluments for enlarging the divisible pool of income tax proceeds. But the Finance Commissions are not authorized to deal with these questions.

(2) The States have been pleading for a larger percentage share of the net income tax proceeds. This plea of theirs has met with success to a large extent.

(3) There is also the intricate question of determining the share of individual States in the share granted to them. Here the States have been pressing for different criteria depending upon the ones which would help them respectively.

One important claimant as a basis of distribution, obviously, would be the assessment. According to this criterion, if in State A twice as much income is assessed as in State B, then State A should get twice as much share as goes to State B. But it is also claimed that the assessment figures are misleading and a better index would be the collection of the tax. Since income tax is progressive and since quite a few assessees go in appeal against the assessment, a more justified basis would be the collection. However, according to others, the real basis ought to be the origin of income which is being taxed, since taxable income may originate in one State but be taxed in another if the tax-payer happens to be the resident of the latter. Thus, we see that in big cities a high collection of income tax is the result of income partly originating elsewhere. "Between them the two States of Bombay and West Bengal account for nearly three-quarters of the collections of income tax in the country; of these collections again about three-quarters are made within the cities of Bombay and Calcutta."[1] Of the several claimants, however, the Finance Commissions have chosen 'collection' as the relevant index. But this index is being given only a *limited weightage*. The successive Commissions have also kept in view the needs of the States.

Apart from the legitimacy of distributing a shareable tax on the basis of need, there are many conceptual difficulties in determining the relative needs of the States. Per capita income, standards of administration and social services, density of population and such like factors come in. However, the Commissions have used population as a proxy for the 'need'. The First Finance Commission was inclined to make use of the per capita income as an index of the relative needs of the States but it was not able "to form any real idea regarding the possible use of such data." It also maintained that variances like

[1]Report of The First Finance Commission, 1952, pp. 73-74.

the proportion of backward castes and tribes in the State population or the area of the State were not relevant in this connection.

The Expert Committee on Financial Provisions of the Union Constitution in 1947 (Sarkar Committee) chose both the collection and population as the basis of distributing income tax between the States. It recommended that the States' share should be 60% of the net income tax proceeds. Of the States' share $33\frac{1}{3}$% should be divided on the basis of population and $58\frac{1}{3}$% on the basis of collection. The remaining $8\frac{1}{3}$% was to be used to help those States to whom the above method of distribution caused hardship. These recommendations, however, were not accepted. The Finance Commissions have been giving a greater weightage to population and the Second Finance Commission thought that the population should be the only basis of determining the share of a State.

All told, it is somewhat strange that the Finance Commissions have tended to determine the shares of the respective States in income tax proceeds on the basis of their fiscal needs while, on logical grounds, it should be on the basis of some indicator of the origin of income. This is more so since grants under Articles 275 and 282 are meant to be based on fiscal needs of both developmental and non-developmental types. Furthermore, once fiscal need is taken as a basis and *is* given such an overwhelming weightage in comparison with tax collections (or assessment as the Fifth and Sixth Commissions did), it is strange that no criterion (or criteria) more satisfactory than the population size was made use of. Economic backwardness, proportion of tribal population in the State, the standards of administrative, economic and social services, and per capita income are all important and relevant factors for the purposes of determining fiscal needs, and they cannot be ignored. In fact, while determining the grants-in-aid of revenues of the States, these factors, more or less, are taken into account.

In view of the expanding needs of the States in terms of their increasing commitments for economic development and social services, the First Finance Commission recommended that the share of the States in the net proceeds of income tax be raised from 50% to 55%. This was to be divided between the States on the basis of collections and population. However, only 20% of the States' share was to be distributed on the basis of collections which were calculated on the basis of 'the actual figures of the collection for the three years ending 1950-51 with suitable adjustments in the case of Part B States.' The remaining 80% of the States' share was to be distributed on the basis of the population of the States according to the census of 1951. The

Commission made these calculations and determined a percentage share for each State which was to remain fixed for the duration for which the recommendations of the Commission were applicable. By applying the same formula for Part C States, the share attributable to them was fixed at 2.75% of the net proceeds as compared with 1% prevailing till then. The remaining 97.25% was to be divided between the States in the following proportions.

Part A States were to get 83.75% of net proceeds of income tax as follows Assam 2.25%; Bihar 9.75%; Bombay 17.50%; Madhya Pradesh 5.25%; Madras 15.25%; Orissa 3.50%; Punjab 3.25%; Uttar Pradesh 15.75; and West Bengal 11.25%.

Part B States were to get the remaining 16.25% as follows: Hyderabad 4.50%; Madhya Bharat 1.75%; Mysore 2.25%; PEPSU 0.75%; Rajasthan 3.50%; Saurashtra 1.00%; and Travancore-Cochin 2.50%.

The Second Finance Commission took a special note of the growing needs of the States and raised their share in the net proceeds of income tax from 55 to 60%. Regarding the determination of individual share of each State, the Commission wanted to make a major policy shift. It said: "While as pointed out by our predecessors, there may be a case for weightage being given to collection in the restricted field of personal income tax, we have come to the conclusion that, taking all factors into account, collection should be completely abandoned in favour of population as the basis of distribution This may result in a loss to a few States where collections are concentrated and their revenue position should be safeguarded by taking into account the overall devolution. As, however, we do not wish to cause a sudden break in the continuity, we propose that the distribution of the States' share should be 10 per cent on the basis of collection and 90 per cent on the basis of population. This should make it easy to complete, in due course, the process of eliminating the factor of collection altogether and distributing the entire amount of the States' share on the basis of population."[2]

The share of income tax proceeds attributable to Union territories was again reduced to 1% while the balance (99% of the net proceeds) was divided between the States in the following proportions:

Andhra Pradesh 8.12%; Assam 2.44%; Bihar 9.94%; Bombay 15.97%; Jammu and Kashmir 1.13%; Kerala 3.64%; Madhya Pradesh 6.72%; Madras 8.40%; Mysore 5.14%; Orissa 3.73% Punjab 4.24%; Rajasthan 4.09%; Uttar Pradesh 16.36%; and West Bengal 10.08%; Total 100.00%.

[2]Report of the Second Finance Commission, 1957, p. 40.

As noted above, the Corporation tax is not shareable with the States. Corporation tax is defined in Article 366 of our Constitution. Earlier, a part of tax on income paid by companies did not meet the requirements of clause (*c*) of this Article which says "that no provision exists for taking the tax so paid into account in computing for the purposes of Indian income tax payable by, or refundable to such individuals" who constitute the company. The Finance Act of 1959 changed the income tax provisions so that the whole of income tax paid by companies came to be defined as corporation tax. This cut into the pool of income tax divisible with States and on their representation, the Third Finance Commission raised the share of the States from 60% to 66⅔% of the net proceeds. The Commission also retained the factor of tax collections as one of the bases for distribution of the income tax proceeds between the States. They asserted that "while population would remain the main factor for the distribution of the net proceeds of income tax amongst the States, the factor of collection should receive active recognition."[3] They further maintained that "it is pertinent to bear in mind the fact that there is over all the country a core of incomes, particularly in the range of personal and small incomes, which should be treated as of local origin."[4] On these considerations, the Commission not only did *not* recommend population as the only basis of distribution, but also restored the earlier formula whereby 80% of the States' share was distributed on the basis of population and the remaining 20% on the basis of collection. The Finance Commission was of the view that along with the concentration of collections come the problems of industrial labour, law and order and the like and therefore the administrative expenditure. The share attributable to the Union Territories was fixed at 2½%. And the remaining balance (97½% of the net proceeds) was divided between different States in the following proportions.

Andhra Pradesh 7.71%; Assam 2.44%; Bihar 9.33%; Gujarat 4.78%; Jammu and Kashmir 0.70%; Kerala 3.55%; Madhya Pradesh 6.41%; Madras 8.13%; Maharashtra 13.41%; Mysore 5.13%; Orissa 3.44%; Punjab 4.49%; Rajasthan 3.97%; Uttar Pradesh 14.42%, and West Bengal 12.09%; Total 100.00%.

The States repeated their plea for enhancing their share in the net proceeds of income tax before the Fourth Finance Commission also. They pleaded that not only the corporation tax was not shareable, the new income tax law had curtailed their share since 1959. The

[3]Report of the Third Finance Commission, 1961, p. 18.
[4]*Ibid.*, p. 18.

proceeds from Corporation tax were increasing at a much rapid rate than those from income tax and this, according to them, showed how they had been deprived of an elastic source of revenue. The yield from corporation tax had increased by over six times while that from income tax had increased by only about one-half. The Fourth Finance Commission accepted their case and raised the share of the States to 75% of the net income tax proceeds. The Commission expressed the opinion that the principles of distribution as between the States should be stable; so it not only chose population and collections as the two bases (like the earlier Commissions) but also maintained like the Third Commission that 80% of the States' share should be distributed amongst them on the basis of population and the remaining 20% on the basis of collections. The Union Territories were given 2.5% and the balance (97.5% of the States' share) was divided between the States in the following proportions:

Andhra Pradesh 7.37%; Assam 2.44%; Bihar 9.04%; Gujarat 5.29%; Jammu and Kashmir 0.73%; Kerala 3.59%; Madhya Pradesh 6.47%; Madras 8.34%; Maharashtra 14.28%; Mysore 5.14%; Nagaland 0.07%; Orissa 3.40%; Punjab 4.36%; Rajasthan 3.97%; Uttar Pradesh 14.60%; and West Bengal 10.91%; Total 100.00%.

The Fifth Finance Commission, apart from being pressed by the States to raise their share in the net proceeds of income tax (suggestions varying from 80% to 100%) was also approached to include *advance income tax collections* for determining the States' share. This was a new technical point and after due reference to the Auditor and Comptroller General the President asked the Commission to consider the division of the advance tax collections also. The share of the States, however, was left at 75% by the Commission. Of the States' share, the share attributable to the Union Territories was fixed at 2.6%. Regarding the bases of determination of shares of the States vis-a-vis each other, the Fifth Commission again reopened the question (in contrast to the view adopted by the Fourth Commission) and restored the formula of the Second Commission, viz., that 90% of the share be distributed on the basis of population and 10% on the basis of *assessment (and not Collection)*. The Fifth Finance Commission considered assessment as a more reliable index than the collection as far as the contributions by different States are concerned. It was stated that the collections were not always directly related to the origin of the income in the same State, and deduction of income tax at source gave a special advantage to the metropolitan and industrial centres. Furthermore, collections are not equal to assessments because in many cases there may be refunds or additional demands after the

assessments. Accordingly, the Fifth Finance Commission adopted assessment instead of collection for determining the share of each State. The respective shares of different States came to be determined as follows:

Andhra Pradesh 8.01%; Assam (including Meghalaya) 2.67%, Bihar 9.99%; Gujarat 5.13%; Haryana 1.73%; Jammu and Kashmir 0.79%. Kerala 3.83%; Madhya Pradesh 7.09%; Maharashtra 11.34%; Mysore 5.40%; Nagaland 0.08%; Orissa 3.75%; Punjab 2.55%, Rajasthan 4.34%; Tamil Nadu 8.18%; Uttar Pradesh 16.01%; and West Bengal 9.11%; Total 100.00%.

The Sixth Finance Commission also agreed with the repeated plea by the States that the exclusion of income tax paid by the companies from the divisible pool since 1959-60 deprived the States of a source which is more elastic than income tax. Just before this exclusion, the income tax paid by the companies was Rs 68.81 crores, and would have risen to Rs 232.5 crores by 1969-70 Furthermore, the Union surcharge was also raised from 10% to 15% in 1971-72, which indirectly limited the scope for taxation by the States. The Commission, in the light of these developments, raised the share of the States in the net proceeds of income tax from 75 to 80%.

Regarding the shares of the States vis-a-vis each other, the Sixth Finance Commission agreed with the Fifth Commission that 90% of it should be distributed on the basis of population. They also agreed with the Fifth Finance Commission that the remaining 10% should be divided between States on the basis of assessment rather than collection. The share of the Union Territories was fixed at 1.79% of the total net proceeds of the income tax *in addition* to the 80% assigned to the States, which was to be divided between them in the following percentage shares:

Andhra Pradesh 7.76%; Assam 2.54%; Bihar 9.61%; Gujarat 5.55%; Haryana 1.77%; Himachal Pradesh 0.60%; Jammu and Kashmir 0.81%; Karnataka 5.33%; Kerala 3.92%; Madhya Pradesh 7.30%; Maharashtra 11.05%; Manipur 0.81%; Meghalaya 0.18%; Nagaland 0.09%; Orissa 3.73%; Punjab 2.75%; Rajasthan 4.50%; Tamil Nadu 7.94%; Tripura 0.27%; Uttar Pradesh 15.23%; and West Bengal 8.89%; Total 100.00%.

The Seventh Finance Commission realised that the fiscal needs of the States had increased and that there was a basis for transferring of more resources to them. It also thought that surcharge on income tax should be transitory in nature; but in India it had come to stay and should, therefore, be considered additional income tax. The Commission, however, could not make any recommendation to the

effect of its sharing with States on account of an express provision of the Constitution to this effect. Accordingly, having set aside 2.19% of the net proceeds as attributable to Union Territories, it allocated 85% of the balance to the States. Ten per cent of their collective share was distributed amongst them in proportion to their respective contribution to income tax revenue and the balance 90% in proportion to their respective population. In October 1978 (when the Commission submitted its Report), income tax was not being levied in Sikkim, but it could be levied in future. Accordingly, the Commission provided two sets of percentage figures of the States' shares, namely (*i*) including Sikkim, and (*ii*) excluding Sikkim, as follows:

Andhra Pradesh (8.021; 8.023); Assam (2.521; 2.522); Bihar (9.536; 9.540); Gujarat (5.957; 5.959); Haryana (1.819; 1.819); Himachal Pradesh (0.595; 0.595); Jammu and Kashmir (0.818; 0.818);, Karnataka (5.440; 5.442); Kerala (3.948; 3.950); Madhya Pradesh (7.354; 7.356); Maharashtra (10.949; 10.953); Manipur (0.188; 0.188); Meghalaya (0.178; 0.178); Nagaland (0.085; 0.085); Orissa (2.738; 2.739): Punjab (2.713; 2.714); Rajasthan (4.362; 4.364); Sikkim (0.035; —); Tamil Nadu (8.048; 8 050); Tripura (0.258; 0.258); Uttar Pradesh (15.422; 15.429); and West Bengal (8.015; 8.018); Total (100.00; 100.00).

Union Excise Duties

At present there are many types of excise duties being levied and collected by the Government of India, namely, Basic Excise Duties, Auxiliary Duties, Earmarked Cesses, Special Duties and Additional Excise Duties (in lieu of sales tax). The auxiliary duties started as special duties like the 'regulatory duties' in 1963 in the wake of Chinese aggression in 1962. The yield from them was not much. They were replaced by what was known as auxiliary duties under the Finance Act, 1973. This Act specifically said that these auxiliary duties were being levied for the purposes of the Union and that their proceeds were not to be divided amongst the States. The Sixth Finance Commission recommended that these duties should also be shared with the States from 1976-77 onwards. Accordingly, they were merged with the basic duties under the Finance (No. 2) Act, 1977. Special duties were imposed in the budget for 1978-79 at the rate of 5% of the basic duties, except on coal, electricity generation and goods under Item 68 of the tariff. Cesses are earmarked for particular purposes mentioned in the relevant legislation. The sharing of the excise duties is *permissible* under Article 272 of the Constitution. Such sharing is done in accordance with law of Parliament on the basis of the recommendations of the Finance Commission. Miscellaneous excise

receipts, special duties, and earmarked cesses go entirely to the Centre and are not shared with the States. The sharing of basic duties started with only three items on the recommendations of the First Finance Commission but now all the basic duties (excluding miscellaneous receipts are shareable between the Centre and the States. The net receipts) from additional excise duties (in lieu of sales tax) is reserved for the States only (excepting the share attributable to Union Territories). The receipts from these basic Union excise duties have been increasing very rapidly and now form the most important source of revenue for the Government of India. While in 1950-51, revenues from excise duties were only Rs 67.54 crores, the budget for 1980-81 put the figure at Rs 5553 crores.

Though the Sarkar Committee had recommended the sharing of excise duty on tobacco on the basis of consumption, their recommendation was not accepted. The States renewed their pleas with the First Finance Commission for the sharing of the excise duties on various grounds. Some of these States even asked for sharing of all the Union excise duties. While all the States were asking for a larger share in the excise duties, they differed on the basis of distribution of the proceeds as between themselves. This is explained on account of the fact that different criteria were advantageous to different States. The First Finance Commission agreed with the States that they should have an additional source of income through sharing of excise duties. But they felt that instead of choosing a large number of items with limited yield it was preferable to have a smaller number of items with a much larger yield which would be of substantial help to the States. Accordingly, they recommended that excise duty on only *three items*, namely, tobacco (including manufactured tobacco), matches, and vegetable products be shared and the States should get 40% of the net proceeds. This recommendation led to the second question, viz. the determination of the shares of the individual States. Various criteria offered themselves—collection, production, consumption and population. Though logically collection appears to be the most relevant criterion, it is not always necessarily so. In a vast country of uneven económic development, the role of the government cannot be easily ignored. The existing regional disparities are partly due to the government's economic policy in the past. Division of excise duties on the basis of collection or production therefore would not be conducive to regional balancing; it will rather tend to accentuate it. Consumption could also be another strong claimant as a relevant basis. But it would be noted that it has also at least two limitations.

Consumption in poorer areas is bound to be less with the result the such States again get a lower share and thus the regional disparities tend to get perpetuated. Secondly, consumption of some items is equally a matter of habit, *e.g.*, of tobacco and sugar. People of some areas are used to consume these items more than the people of other areas. Accordingly, population appears to be the most justifiable basis for respective shares of the States. And if we want to bring in the factor of regional equality and fiscal needs, then the population index should be supplemented with the indices of backwardness such as per capita income. In practice, however, the Finance Commissions have heavily relied on population as the basis of distributing the proceeds of the excise duties.

The First Finance Commission recommended that the population of both Part A and Part B States should be aggregated and each State should get its share determined on the basis of the percentage that its population bears to the respective sub-total. Another recommendation of the First Finance Commission was that Bombay, Madras and Madhya Pradesh should also be allowed to levy taxation on tobacco (as other States could) and the compensation payable to them for refraining from imposing this tax should be stopped. 40% of the net proceeds of excise duties on the three items were to be distributed amongst various States on the following percentage basis; Assam 2.61%; Bihar 11.60%; Bombay 10.37%; Hyderabad 5.39%; Madhya Bharat 2.29%; Madhya Pradesh 6.13%; Madras 16.44%; Mysore 2.62%; Orissa 4.22%; PEPSU 1.00%; Punjab 3.66; Rajasthan 4.41%; Saurashtra 1.19%; Travancore-Cochin 2.68%; Uttar Pradesh 18.23%: and West Bengal 7.16%; Total 100.00%.

By the time of the Second Finance Commission, the revenue from Union excise duties had increased from Rs 83 crores in 1952-53 to Rs 254.6 crores in 1957-58, partly due to the elasticity of the existing duties and partly due to the extension of these duties from 13 to 29 commodities. The Second Finance Commission noted that there were pleas for extending the sharing of excise duties to all the commodities but they took only one step forward and widened the range to include (besides the three existing items namely, matches, tobacco including manufactured tobacco and vegetable products) sugar, tea, coffee, paper and vegetable non-essential oils (thus raising the number of duties to be shared to eight). At the same time, however, they reduced the share of the States from 40 to 25% of the net proceeds. The First Finance Commission had expressed the desire to build up consumption statistics for future use. The Second Finance Commission also agreed that consumption was a desirable basis for determining

the shares of respective States but such reliable data did not exist Hence they also adopted population as the basis for distribution, but recommended that 90% of the States' share be distributed on the basis of population and the remaining 10% be used for adjustments since in practice the population criterion would favour some particular States. The States' share was to be divided between the individual States in the following way:

Andhra Pradesh 9.38%; Assam 3.46%; Bihar 10.57%; Bombay 12.17%; Kerala 3.84%; Madhya Pradesh 7.46%; Mysore 6.52%; Madras 7.56%; Orissa 4.46%; Punjab 4.59%; Rajasthan 4.71%; Uttar Pradesh 15.94%; West Bengal 7.59%; and Jammu and Kashmir 1.75%; Total 100.00%.

The Second Finance Commission also had to deal with the question of Additional Excise Duties for the first time whose entire net proceeds were to be distributed amongst the States. As a result of a decision taken by the National Development Council in December 1956, a scheme of levying additional excise duties in lieu of sales tax by States on certain commodities was adopted. In this connection, the Additional Duties of Excise (Goods of Special Importance) Act. 1957 was passed. Such an arrangement was considered to be convenient to the trade and helpful to the authorities in checking evasion. Technically, the States remain free to opt out of the scheme and reimpose sales tax subject to the forefeiture of their share of the revenue from the additional excise duties on these commodities. However, in practice, the States are prevented from this by Section 14 of the Central Sales Tax Act, 1956 according to which these goods have been declared as 'goods of special importance.' Because of this declaration, the States cannot impose sales tax on these commodities at a rate which exceeds the one specified in the Act.

Moreover, sales tax on these commodities can be levied only at one stage and the local tax is to be refunded if such goods subsequently become subject to inter-State sales tax. On account of all these repercussions, therefore, the State do not find it worthwhile to reimpose the sales tax and opt out of the scheme. The States, however, were feeling dissatisfied with the scheme because of the fact that this source of revenue was not fully exploited by the Union Government. The Government of India, therefore, referred the matter to the Fifth Finance Commission. The Fifth Finance Commission noted that the States had "complained that the Government of India, while increasing basic excise duties and introducing special excise duties on the same commodities, had kept unchanged the

rates of additional excise duties."[5] These duties were generally specific as compared with *ad valorem* sales tax in lieu of which they had been levied. This made their revenue yield still less elastic. The trade interests, on the other hand, were in favour of continuation of the scheme. Accordingly, on recommendation of the Fifth Finance Commission, the question was discussed by the representatives of the Government of India and the State Governments. Finally, the National Development Council agreed in December 1970 that the scheme should continue subject to the fulfilment of certain conditions, especially that the incidence of the additional duties be raised, in stages, to 10.8% of the value of the clearance. This was accepted by the Government of India and the rates were accordingly raised in the subsequent years. The yield from them was Rs 32.50 crores in 1957-58 when they were first levied; a sum of Rs 372.74 crores was estimated under this head in the Central Government budget for 1980-81.

At the time of the Second Finance Commission, the only commodities subject to the additional excise duties in lieu of sales tax were mill-made cloth, sugar and tobacco. The Commission, in their recommendations were to make sure that each State was guaranteed at least the revenue realized from the levy of sales tax for the financial year 1956-57 in that State. The Commission recommended that of the net proceeds of these duties, 1% should be assigned to the Union Territories, and 1¼% to Jammu and Kashmir. Out of the balance, the States put together should get a total of Rs 32.50 crores by way of guaranteed amounts -Rs 19.76 crores for mill-made cloth, Rs 7.18 crores for sugar and Rs 5.56 crores for tobacco. After setting aside the guaranteed amounts, the balance was divided amongst the States on the basis of 'consumption' corrected with reference to population as follows: Andhra Pradesh 7.81%; Assam 2.73%; Bihar 10.04%; Bombay 17.52%; Kerala 3.15%; Madhya Pradesh 7.16%; Madras 7.74%; Mysore 5.13%; Orissa 3.20%; Punjab 5.71%; Rajasthan 4.32%; Uttar Pradesh 17.18%; and West Bengal 8.31%; Total 100.00%.

The Third Finance Commission noted the fact that the financial needs of the States were increasing rapidly due to various developmental and other efforts while their resources were lagging behind. Accordingly, the Third Commission extended the principle of sharing the duties to all the commodities from which the yield of excise

[5]Report of the Fifth Finance Commission, p. 39.

duty was Rs 50 lakhs or more in 1960-61.[6] They, however excluded the duty on motor spirit for special purpose grants for the development of communications. These recommendations raised the number of duties to be shared to 35, but the share of the States was reduced to 20% of the net proceeds.[7] Regarding the distribution of the States' share between the individual States, the Commission observed that consumption could not be taken as the correct criterion for distribution especially now that intermediate and producer goods were also included. The Commission observed that while determining the shares of individual States, in addition to population, relative financial weakness of a State, and the percentage of Scheduled Tribes and Backward Classes in its population must also be taken into account. Without disclosing the exact formula assigning the weightage to these factors, the Commission recommended that the percentage shares of individual States be fixed as follows:

Andhra Pradesh 8.23%; Assam 4.73%; Bihar 11.56%; Gujarat 6.45%; Jammu and Kashmir 2.02%; Kerala 5.46%; Madhya Pradesh 8.46%; Madras 6.08%; Maharashtra 5.75%; Mysore 5.82%; Orissa 7.07%; Punjab 6.71%; Rajasthan 5.93%; Uttar Pradesh 10.68%; and West Bengal 5.07%; Total 100.00%.

Regarding the distribution of additional excise duties, the Third Finance Commission followed the pattern laid down by the Second Commission. It allotted 1% of the net proceeds to Union territories and 1½% to Jammu and Kashmir. Of the balance, it also set aside the guaranteed sums of Rs 32.50 crores and proceeded to distribute the rest amongst the States on a percentage basis. Like the Second Commission, it also maintained that consumption in each State would be the best index to distribute the proceeds of these duties, but reliable consumption figures were not available. For example, consumption figures regarding cigarettes are in terms of numbers of cigarettes while the additional duty on cigarettes is at *ad valorem* rates. Figures of cloth consumption are in terms of the value of

[6]There were thirty-five such commodities.

[7]"We consider that 20% of the net proceeds of Union duties of excise on all commodities on which such duties are collected, would be appropriate for the purpose we have in view. For purposes of our distribution, we have included all the commodities on which duties were collected in 1960-61 being the last year preceding the third Five Year Plan, excluding (except silk fabrics) those on which the yield was below Rs 50 lakhs a year. We exclude, however, from this computation the duty on motor spirit, as we propose elsewhere that a sum of Rs 36 crores being about 20 per cent of its yield should be utilised for maintenance, and improvement of communications and distributed as a special purpose grant." (Third Finance Commission Report, para 44.)

cloth while the additional excise duties are on the basis of the variety and the value of cloth. While the Second Commission had used the consumption figures and adjusted the State shares with reference to population figures, the Third Commission proceeded to estimate the percentage increase in sales tax revenue in each State since 1957-58 and modified these figures with the population factor. This approach had its own limitations in the sense that the increase in sales tax revenue from *other* items is not necessarily indicative of the possible increase in the sales tax revenue from the items under consideration. The increase in the yield from sales tax from *other* items depends upon the choice of those items, the rates of sales tax, the growth in their trade transactions and such like factors, which cannot be guaranteed to be directly proportionate to the possible sales tax revenue which could be obtained from the items subjected to additional excise duties.

Meanwhile, additional excise duty on silk fabrics in lieu of sales tax had also been levied, the yield from which was Rs 4 lakhs per annum. The Third Finance Commission included this sum also in the guaranteed amount (raising it from Rs 32.50 crores to Rs 32.54 crores). The Union territories were assigned 1% of the net proceeds, and the share of Jammu and Kashmir was raised to 1¼%. The final distribution of the percentage shares of different States after the guaranteed sums turned out to be as shown below:

Andhra Pradesh 7.75%; Assam 2.50%; Bihar 10.00%; Gujarat 5.40%; Kerala 4.25%; Madhya Pradesh 7.00%; Madras 9.00%; Maharashtra 10.60%; Mysore 5.25%; Orissa 4.00%; Punjab 5.25%; Rajasthan 4.00%; Uttar Pradesh 15.50%; and West Bengal 9.00%; Total 100.00%.

The Fourth Finance Commission completed the process of extending the principle of sharing the excise duties. It had been the practice of the Central Government to bring in additional commodities under excise duties with almost every budget so that between one Commission and the next, there would be some excise duties which would not be shared simply because they did not exist at the time of the previous Commission. The Fourth Finance Commission not only recommended the sharing of all the existing duties but also the ones which would be imposed later. It recommended that "all Union Excise Duties currently levied (excluding regulatory duties, special excise duties and cesses earmarked for special purposes) as also those that might be levied in the next five years should be shared

between the Union and the States."[8] The share of the States was, however, retained at 20% of the net proceeds. Furthermore, while determining the shares of the States vis-a-vis each other, the Commission disclosed the weightage given by it to population and economic and social backwardness *viz.*, 80% on the basis of population and 20% on the basis of economic and social backwardness, the latter being indicated by *per capita* value added by manufacturing, percentage of workers to the total population and the like. On the basis of these considerations, the Fourth Commission recommended that the respective percentage shares of different States (in the 20% of the net proceeds of excise duties being assigned to them) should be as follows:

Andhra Pradesh 7.77%; Assam 3.32%; Bihar 10.03%; Gujarat 4.80%; Jammu and Kashmir 2.26%, Kerala 4.16%; Madhya Pradesh 7.40%; Madras 7.18%; Maharashtra 8.23%; Mysore 5.41%; Nagaland 2.21%; Orissa 4.82%; Punjab 4 86%; Rajasthan 5.06%; Uttar Pradesh 14.98%; and West Bengal 7.51%; Total 100.00%.

Coming to the distribution of additional excise duties under the recommendations of the Fourth Commission, we note that the Commission adopted a new basis for dividing the amounts over and above the guaranteed sums, namely, that "the distribution of the balance over the total of guaranteed amounts may be made on the basis of the proportion of sales tax revenue realized in each State to the total sales tax collections in all the States taken together"[9] over the years 1961-62 to 1963-64. This formula also had limitations similar to the ones found in the case of the Third Commission and so need not be pointed out again. The Fourth Commission allotted 1% of the net proceeds to the Union territories, 1½% to Jammu and Kashmir, 0.05% to Nagaland and the balance 97.45% was divided between the remaining States, after setting aside the guaranteed sums of Rs 32.54 crores as indicated below:

Andhra Pradesh 7.42%; Assam 1.98%; Bihar 6.17%; Gujarat 7.43%; Kerala 5.65%; Madhya Pradesh 4.62%; Madras 11.13%; Maharashtra 19.87%; Mysore 5.21%; Orissa 2.85; Punjab 5.01%; Rajasthan 3.17%; Uttar Pradesh 7.83%; and West Bengal 11.93%; Total 100.00%.

The Fifth Finance Commission was pressed by the States for a larger percentage share of the net proceeds of the excise duties to which the Commission did not agree and kept their share at 20%.

[8]Report of the Fourth Finance Commission, 1965, p. 73.
[9]Report of the Fourth Finance Commission, 1965, p. 34.

But it recommended that the yield from special excise duties should be included for determining the States' share during 1972-73 and 1973-74. Regarding the determination of individual States' shares the Commission adhered to the rule that 80% of the share should be distributed on the basis of population and the remaining 20% on the basis of backwardness. However, it spelt out the determination of the index of backwardness more fully. It chose *seven* components of backwardness *viz.*, the per capita income, the scheduled tribes population, the number of factory workers per lakh of population, net irrigated area per cultivator. length of railways and surface roads per 100 sq kms, shortfall in the number of school-going children as compared with those of school-going age, and the number of hospital beds per 100 population and assigned equal weightage to all these seven components. They recommended that two-thirds of the 20% proceeds be divided between those States whose per capita income was below the national per capita income, "in proportion to the short-fall of the State's per capita income from other States, multiplied by the population of the State." Per capita income of Nagaland for this purpose, was considered equal to be that of Assam. The remaining one-third of 20% was recommended to be distributed on the basis of a composite index of the remaining components of backwardness. The actual percentage shares of different States were fixed as follows:

Andhra Pradesh 7.15%; Assam 2.51%; Bihar 13.81%; Gujarat 4.17%; Haryana 1.49; Jammu and Kashmir 1.12%; Kerala 4.28%; Madhya Pradesh 8.48%; Maharashtra 7.93%; Mysore 4.65%; Nagaland 0.08%: Orissa 4.72%; Punjab 2.17%; Rajasthan 5.28%, Tamil Nadu 6.50%; Uttar Pradesh 18.82%; West Bengal 6.84%: Total 100.00%.

Regarding the distribution of the additional excise duties, the Fifth Finance Commission agreed that sales tax yield was not a very reliable base, especially when sales tax was being levied on all types of goods including luxuries, raw materials, intermediate goods and consumption goods. The Fifth Finance Commission, therefore, gave an *equal weightage* to population and sales tax collection. It assigned 2.05% of the net proceeds to the Union territories, 0.83% to Jammu and Kashmir, and 0.09% to Nagaland. Of the remaining 97.03% of the net proceeds, the guaranteed sums were set apart and the balance was divided between the States in the following manner:

Andhra Pradesh 8.13%; Assam 2.47%; Bihar 8.40%; Gujarat 6.33%; Haryana 1.70%; Kerala 4.84%; Madhya Pradesh 6.34%; Maharashtra 13.89%; Mysore 6.00%; Orissa 3.13%; Punjab 2.98%;

Rajasthan 4.42%; Tamil Nadu 9.63%; Uttar Pradesh 12.99%; West Bengal 8.75%; Total 100.00%.

The Sixth Finance Commission took note of the fact that the Fifth Commission had recommended the inclusion of the special duties in the divisible pool, but that regulatory duties were still out of the divisible pool. The yield from these regulatory duties however was nil in 1970-71 and even in the budget for 1971-72 no credit was taken for them. However, the Government of India invoked the provision of Section 12 of the Finance Act, 1971 to levy some regulatory duties when refugees started coming from Bangladesh The items subjected to these regulatory duties stood at 25 in number in 1975-76 and important among them were iron and steel products, plastics, cigarettes, aluminium, paper, jute manufactures, copper and copper alloys, cement, unmanufactured tobacco, and steel ingots. The yield from these duties was Rs 22.88 crores in 1971-72 and Rs 80.37 crores in 1972-73 (RE). However, in 1973, these regulatory duties were replaced by auxiliary duties under the Finance Act of 1973, and according to the Act the yield from these duties was specifically reserved for the Union only. The States however pleaded for the inclusion of these duties also in the divisible pool for many reasons. *Firstly*, they did not want to lose such a source of revenue which, from all accounts, looked like staying on a permanent basis. *Secondly*, they were afraid that the Centre would be raising the rates of auxiliary duties at the expense of the divisible duties and thus deprive the States of their legitimate potential share. Thus the yield from these duties in 1973-74 was Rs 98 40 crores, and rose to Rs 253.16 crores in 1976-77 (the last year of their existence). *Thirdly*, the effect of the auxiliary duties was indistinguishable from that of the basic excise duties. The Sixth Finance Commission accepted these arguments and recommended that the yield from auxiliary duties should also become divisible from 1976-77 onwards.

The States were also pressing for a larger percentage share from the yield of excise duties to be assigned to them. Such a course, however, would have left the Centre with smaller resources to aid the relatively backward States with larger grants. Accordingly, the Commission decided to retain the States' share at 20% of the net proceeds of these duties (inclusive of the auxiliary duties from 1976-77 onwards). Regarding the problem of determining the shares of individual States, the Commission was flooded, as usual, with different proposals. Like the earlier Commissions, the Sixth Finance Commission also emphasised the backwardness as a distinct criterion, but reopened the question of determining the index of backward-

ness. The Fifth Finance Commission had divided the States into two categories in terms of States having per capita incomes which were higher than the national average and the States in which the per capita incomes were below the national average. Regarding other variables constituting the component elements of an index of backwardness, the Sixth Commission found that such a composite index was not a reliable one. *Firstly*, low per capita income of a State could be both a cause and a consequence of economic backwardness and *secondly* even some poor States were trying to maintain a comparatively higher level of social services. According to them, therefore, a composite index of backwardness could be both misleading and redundant. It was enough to rely only on the per capita incomes of various States as the adequate indicator of their relative backwardness. It requested and obtained from the CSO the estimates of State Domestic Product for three years (1967-68, 1968-69 and 1969-70) and used them as the sole indicator of economic backwardness. However, it recommended that 75% (instead of 80% as till then) of the States' share should be distributed between them on the basis of population and the remaining 25% (instead of 20% as till then) on the basis of economic backwardness. Accordingly, the percentage share of each State was determined as follows:

Andhra Pradesh 8.16; Assam 2.71; Bihar 11.47; Gujarat 4.57; Haryana 1.53; Himachal Pradesh 0.63; Jammu and Kashmir 0.90; Karnataka 5.45; Kerala 3.86; Madhya Pradesh 8.15; Maharashtra 8.58; Manipur 0.21; Meghalaya 0.19; Nagaland 0.11; Orissa 4.06; Punjab 1.87; Rajasthan 5.00; Tamil Nadu 7.43; Tripura 0.30; Uttar Pradesh 17.03; West Bengal 7.79; Total 100.00.

Regarding the additional duties of excise in lieu of sales tax, the Sixth Finance Commission changed the policy of setting aside the guaranteed sums and distributing the rest. They interpreted the relevant term of reference to mean that there was no need to set aside the guaranteed amounts since in any case, each State would be getting more than the guaranteed amount. The terms of reference of the Finance Commission also stated "that the share accruing to each State shall not be less than the revenue realized from the levy of sales tax for the financial year 1956-57 in that State."[10] The Commission estimated that the net proceeds of these duties after meeting the share of the Union Territories, for the five years would be around Rs 1,037 crores as against the guaranteed sums of Rs 162 crores for the five-year period.

[10]Sixth Finance Commission, "Terms of Reference."

The Commission further observed that the earlier Finance Commissions were not giving weightage to economic backwardness of States in distributing the duty proceeds between them and were only trying to estimate the sales tax revenue which the respective States would have got had the scheme of additional excise duties been not in operation. "In other words, the Finance Commission have recognized the principle of compensation to be the only valid principle in the distribution of additional excise duties. Other considerations such as preferential treatment for backward States, however, valid in relation to other Central taxes, are totally irrelevent to any scheme of distribution of additional excise duties. Their levy by the Centre is in pursuance of what is equivalent to a tax rental agreement."[11]

The Sixth Finance Commission also noted that the earlier Commissions were agreed that consumption was the best measure of the potential yield of a sales tax and that the earlier Commissions were only busy finding out the best way of getting at the consumption indices. It however noted that reliable consumption statistics were still not available. It also agreed with the Fifth Finance Commission that sales tax collection of other commodities was not a good proxy for the potential yield of sales tax on the commodities under consideration, because they do not indicate the consumption of the commodities on which the duties are being levied. After due consideration of various alternatives, the Sixth Finance Commission came to the conclusion that the three factors which should be chosen as the basis of distribution were population, State Domestic Product at current prices and production. The population was proxy of consumption and coupled with production it would give a good basis for potential sales tax yield. The Domestic Product of a State for three years, 1967-68, 1968-69, and 1969-70 was used as an indicator of its backwardness (and sales tax being on *ad valorem* basis, the State Domestic Product was to be measured at current prices). In the final analysis, the Commission recommended that 1.41% of the net yield of the additional duties of excise (inclusive of auxiliary duties from 1976-77 ownwards) be retained by the Union for Union Territories and the balance 98.59% be distributed between the States in the following manner:

Andhra Pradesh 8.39%; Assam 2.47%; Bihar 9.36%; Gujarat 5.91%; Haryana 1.94%; Himachal Pradesh 0.59%; Jammu and Kashmir 0.73%; Karnataka 5.62%; Kerala 3.58%; Madhya Pradesh

[11]Sixth Finance Commission Report, para 8.

6.98%; Maharashtra 11.65%; Manipur 0.17%; Meghalaya 0.17%; Nagaland 0.08%; Orissa 3.59%; Punjab 2.67%; Rajasthan 4.17%; Tamil Nadu 7.27%; Tripura 0.25%; Uttar Pradesh 16.10%; West Bengal 8.31%; Total 100.00%.

The Seventh Finance Commission proceeded on the assumption that sharing of Central taxes should have a predominant role in the transfer of resources from the Centre to States and that grants-in-aid under Article 275 should be only a residual transfer. Accordingly, the Commission recommended that the entire net collection of excise duty on the generation of electricity attributable to each State be transferred to that State. Further, 40% of the net collection of all the other excise duties, excluding proceeds of additional duties of excise in lieu of sales tax and cesses levied under special Acts and earmarked for special purposes, be distributed amongst States. As regards the shares of individual States, the Commission made it clear that sharing of these proceeds should be determined with a view to reducing the inter-State disparities. But it found that it was desirable to adopt the overall indicators of backwardness instead of partial indicators. Accordingly, the Commission decided that the shares of the individual States should be determined by giving equal weight to (*i*) the population factor, (*ii*) the inverse of the per-capita State Domestic Product, (*iii*) the percentage of the poor in each State, and (*iv*) a formula of revenue equalisation which the Commission had worked out. At the time of the Commission's Report, Union excise duties were not leviable in Sikkim and therefore the State was not entitled to a share in the net proceeds of these duties. But in future, these duties could be levied there. Therefore, the Commission recommended two sets of percentage shares (excluding Sikkim and including Sikkim) as follows:

Andhra Pradesh (7.698; 7.691); Assam (2.793; 2.793); Bihar (13.025; 13.021); Gujarat (4.103; 4.101); Haryana (1.177; 1.177); Himachal Pradesh (0.521; 0.521); Jammu and Kashmir (0.839; 0.839); Karnataka (4.877; 4.876); Kerala (4.036; 4.035); Madhya Pradesh (8.727; 8.725); Maharashtra (6.633; 6.632); Manipur (0.218; 0.218); Meghalaya (0.200; 0.200); Nagaland (0.097; 0.097); Orissa (4.682; 4.682); Punjab (1.226; 1.226); Rajasthan (4.813; 4.813); Sikkim (—; 0.028); Tamil Nadu (7.641; 7.637); Tripura (0.373; 0.373); Uttar Pradesh (18.293; 18.290); West Bengal (8.028; 8.025); Total (100.00; 100.00).

Faced with the task of distributing the net proceeds of additional duties of excise in lieu of sales tax amongst the States, the Seventh

Finance Commission found that the difficulties arising from lack of reliable statistics of consumption of articles under question still persisted. It requested the Government to arrange for collection of reliable data in this regard for the benefit of future Finance Commissions. The Commission also found that additional duties of excise were not being levied in Sikkim and the State was levying sales tax on textiles only. Accordingly, the Commission decided that Sikkim should get a share of additional duties on sugar and tobacco, but not of duties on textiles. However, it provided for the eventuality of Sikkim giving up its sales tax on textiles and getting entitled to a share of the proceeds of that duty also.*

Though faced with inadequate data on consumption, the Seventh Finance Commission tried to evolve suitable proxies for the same. As regards consumption of sugar, averages of the despatches to Union Territories and each State in three years 1974-77 were estimated. The shares of the Union Territories and of each State in the total of the average despatches in these three years were taken as their respective shares in the net proceeds of the duties on sugar. The average per capita domestic product of a State at current prices for three years 1973-76 multiplied by its population according to 1971 census (The Commission was obliged by its terms of reference to use 1971 census figures wherever population was to be a factor in determining respective shares of States) was taken to represent its consumption of textiles and tobacco. The share of a State in the total net proceeds of duties on textiles and tobacco was determined by the percentage of its estimated consumption of these commodities in the corresponding total for all States. On this basis, the Commission recommended that 3.271% of the duty on sugar should be retained by the Centre as the portion attributable to Union Territories. The corresponding figure for textiles and tobacco each was 2.192. The balance in each case was to be divided amongst the States as shown in Table 18.1

Estate Duties

Estate Duty revenue on properties other than agricultural lands is to be assigned to the States under Article 269 of the Constitution. These duties have been levied since 1957. Further, in certain States, estate duty on agricultural lands is also imposed and collected by the Government of India and such net proceeds are assigned to only those States from whom this duty is collected.

* Tables 18.2, 18.3 and 18.4 summarize the recommendations of the Finance Commissions on income-tax, Union excise duties and additional excise duties.

TABLE 18.1

PERCENTAGE SHARE OF STATES IN ADDITIONAL DUTIES OF EXCISE

States	Sugar	Textiles Without Sikkim	Textiles With Sikkim	Tobacco
Andhra Pradesh	5.245	8.020	8.018	8.018
Assam	2.408	2.298	2.297	2.297
Bihar	5.933	7.221	7.219	7.219
Gujarat	8.712	6.015	6.013	6.013
Haryana	2.656	2.790	2.789	2.789
Himachal Pradesh	0.860	0.734	0.734	0.734
Jammu and Kashmir	0.831	0.744	0.744	0.744
Karnataka	4.901	6.083	6.081	6.081
Kerala	3.783	4.020	4.019	4.019
Madhya Pradesh	6.019	6.422	6.419	6.419
Maharashtra	17.062	13.510	13.506	13.506
Manipur	0.143	0.185	0.185	0.185
Meghalaya	0.029	0.171	0.171	0.171
Nagaland	0.115	0.084	0.084	0.084
Orissa	2.178	3.457	3.456	3.456
Punjab	6.220	4.270	4.268	4.268
Rajasthan	4.729	4.366	4.365	4.365
Sikkim	0.057		0.034	0.034
Tamil Nadu	6.449	7.710	7.707	7.707
Tripura	0.172	0.257	0.256	0.256
Uttar Pradesh	13.184	12.549	12.544	12.544
West Bengal	8.254	9.094	9.091	9.091
Total	100.000	100.000	100.000	100.000

TABLE 18.2

SHARING OF INCOME TAX PROCEEDS

Finance Commission	%age share in the divisible pool: Of the centre	%age share in the divisible pool: Of State & UTs/Part C States	%age share of UTs Part C States in (3)	%ag share of States in (3)	Distribution of (5) amongst states Weights assigned to: Population	Collection	Assessment
1	2	3	4	5	6	7	8
I	45	55	2.75	97.25	80	20	
II	40	60	1.00	99.00	90	10	
III	33⅓	66⅔	2.50	97.50	80	20	
IV	25	75	2.50	97.50	80	20	
V	25	75*	2.60	97.40	90		10
VI	20**	80**	1.79†	100.00	90		10
VII	15**	85**	2.19†	100.00	90	10	

* Inclusive of advance tax collections
† Percentage share of total net proceeds
**Divisible pool net of Union Territories share

TABLE 18.3

SHARING OF NET COLLECTION OF UNION EXCISE DUTIES

Finance commission	*Number of items*	*%age share of States in the divisible pool*	*Division of (3) amongst States: %age Weights assigned to*		
			Population	*Economic backwardness*	*Adjustment*
1	*2*	*3*	*4*	*5*	*6*
I	3	40	100	-	
II	8	25	90	—	10
III	35	20	Formula Not Disclosed		
IV	All Items*	20	80	20	
V	All Items**	20	80	20$	—
VI	All Items***	20	75	25$$	–
VII	All Items****	40	$$$		

* Excluding regulatory, special and earmarked cesses but including those which might be imposed in future.

** Excluding regulatory duties and earmarked cesses but including special duties for the years 1972-73 and 1973-74

$ Index of economic backwardness composed of seven components Two-third of this 20% to be assigned to States with a per capita income below the national average and one-third to be assigned to States with a per capita income above the national average

*** All items inclusive of auxiliary duties (which had replaced regulatory duties since 1973 74) from 1976-77 onwards

$$Economic backwardness of a State is indicated by its per capita income

**** Entire duty on generation of electricity attributable to a State to be transferred to that State All other basic duties to be shared

$$$Equal weights to (*i*) population, (*ii*) inverse of per capita State Domestic Product, (*iii*) percentage of poor in the State population, (*iv*) a formula of revenue equalisation worked by the Commission.

During 1974-79, net proceeds of this duty, as per recommendations of the Sixth Finance Commission were being distributed amongst States as shown on p. 371.

TABLE 18 4

DISTRIBUTION OF ADDITIONAL DUTIES OF EXCISE AMONGST STATES

Finance commission	*To UTs*	*To J & K*	*Guaranteed amount*	*Basis for the division of the balance*
II	1%	1½%	Yes	Consumption corrected with respect to population.
III	1%	1½%	Yes	Percentage increase in sales tax revenue since 1957-58 modified with population factor.
IV	1%	1½%	Yes	Percentage of sales tax revenue realized in each State to total sales tax revenue of all States during 1962-64.
V	2.05%	0.83 0.09*	Yes	Equal weightage to population and sales tax collection.
VI	1.41%	—	No	(*i*) Population as a proxy for consumption, (*ii*) State domestic product for 1967-68, 1968-69 and 1969-70 at current prices, and (*iii*) production.
VII	3.271% for sugar; 2.192% each for textiles and tobacco	—	No	For sugar : Average despatches of sugar in 3 years 1974-77 as an indicator divided by average despatches to all States. For textiles and tobacco : Average per capita product of a State at current prices for 1971-76 multiplied by population as per 1971 census divided by the corresponding total for all States.

*To Nagaland.

(*i*) 2.5% of the net proceeds were retained by the Centre as attributable to the Union Territories;

(*ii*) The balance 97.5% was divided into two portions in the ratio of the gross values of movable and immovable properties assessed during the year:

(*a*) The portion which was thus ascribed to immovable property was distributed amongst States in the ratio of the gross value of the immovable property located in each State and brought into assessment in that year;

(*b*) The portion ascribed to movable property was distributed amongst the States in the ratio of their respective population.

With effect from 1979-80, the distribution of the net proceeds among the states is being governed by an amendment of the Act in accordance with the recommendations of the Seventh Finance Commission. The Commission has done away with the distinction between proceeds of duty attributable to movable and immovable property and has recommended that the estate duty to each State be determined in proportion to the gross value of the property (other than agricultural land) in each State. The property located abroad is to be deemed to be located in the State where it is brought to assessment.

THE FINANCE COMMISSION AND GRANTS-IN-AID

Indian Constitution provided three types of grants.[12] *Firstly*, under Article 273 it provided that the jute growing States of Assam, Bihar, Orissa and West Bengal would be given grants-in-aid of the revenues, in lieu of a share in export duty on jute and jute products. These grants would be given for a period of 10 years or for a shorter period if such export duty was abolished earlier. These grants are, therefore, over now.

Secondly, under Article 275, grants are given by the Government of India to States which are in need of assistance for meeting their revenue gaps. Such grants can be of different amounts for different States depending upon the estimates of such needs. The Article also provides that a State would also be getting grants for meeting "the costs of such schemes of development as may be undertaken by the States with the approval of the Government of India for the purpose of promoting the welfare of the Scheduled Tribes in that State or raising the level of administration of the Scheduled Areas therein to that of the administration of the rest of the areas of that State."

Thirdly, Article 282 allows both the Central and State Governments

[12]Article 278 which covered the grants to States for needs arising out of the merger of the erstwhile Princely States with Part A States and the emergence of Part B States was repealed by the Constitution (Seventh Amendment) Act, 1956.

to "make any grants for any public purpose," even when the purpose for which the grant is being made is not within the legislative powers of Parliament or the State Legislature concerned. These are therefore discretionary grants and provide a great flexibility and nearly unlimited scope for transferring of resources from one government to another.

A *fourth* kind of grant has accidentally come up, namely, grants in lieu of tax on railway passenger fares. Technically, it comes under discretionary grants, though historically these grants were started when the tax on railway passenger fares was abolished in 1961.

A *fifth* kind of grant has resulted from the introduction of wealth tax on agricultural property with effect from the assessment year 1970-71 by the amendment of the Wealth Tax Act of 1957, as amended by the Finance Act of 1969. Wealth tax is not shareable with the States either on an obligatory or on permissive basis. Therefore, the Centre decided to pass the net collections to the States by way of grants-in-aid. The figures involved are very small (Rs 81 lakhs as per 1980-81 Budget). The Sixth Finance Commission had recommended that the grant should be distributed amongst the States in proportion to the value of agricultural property situated in each State and brought to assessment in each year. The Seventh Finance Commission has recommended that the share of each State should be *equivalent to the net collection* in that State in each year.

Grants in Lieu of Jute Export Duty

We have seen above that four States, namely—Assam, Bihar, Orissa and West Bengal were entitled to those grants so long as the Government of India were imposing and collecting any export duty on jute or jute products, but in any case these grants were to cease after 10 years from the commencement of the Constitution. The First Finance Commission interpreted the provision of the Constitution to mean that the four listed jute producing States were to get a *compensation and not a share* in the jute export duty. The idea, it was maintained, was to compensate these States against a sudden loss of some revenue. Had it been the intention of the Constitution makers to give these States a share in the export duty, it would have been mentioned therein and those other States which started growing jute later on would also have been included. Proceeding on these arguments, the First Finance Commission took the year 1949-50 as the base year (when the sharing of the duty came to an end) when the yield from the export duty was Rs 968 lakhs. At that time the States' share in export duty was 62½%, which gives a figure of Rs 605 lakhs. The Commission further argued that the total export of raw jute and jute pro-

ducts in that year was 10.39 lakh tonnes. During the same year, the production of raw jute in the four States under consideration was only 5.42 lakh tonnes. Even assuming that all their jute production was exported in raw or manufactured form, their share in Rs 605 lakhs would not exceed (Rs 605 × 5.42 ÷ 10.39) = Rs 315 lakhs approximately. This amount was recommended as a grant to be distributed between the four States in proportion of their raw jute production. Accordingly, the grants recommended (per annum) were as follows: Assam Rs 75 lakhs; Bihar Rs 75 lakhs; Orissa Rs 15 lakhs and West Bengal Rs 150 lakhs.

The Second Finance Commission agreed with the recommendations of the First Finance Commission, and only a minor adjustment on account of the transfer of certain areas from Bihar to West Bengal was made. Accordingly, during the Second Plan these grants (per annum) amounted to: Assam Rs 75 lakhs; Bihar Rs 72.3 lakhs; Orissa Rs 15 lakhs; West Bengal Rs 152.69 lakhs.

Grants in Lieu of Tax on Railway Passenger Fares

This tax was levied by the Government of India under Article 269 in 1957 by the passage of the Railway Passenger Fares Tax Act, 1957. We have seen earlier that this is one of those taxes whose net proceeds are to be wholly assigned to the States. The Second Finance Commission was the first to deal with the distribution of the proceeds of this tax. The Commission observed that the ideal way of distributing the proceeds between the States would be to determine the actual tax collection on each ticket according to the mileage range in each State. Such a calculation, however, was not possible. Instead it adopted the method of dividing the earnings of each zonal railway between different States in proportion to the route mileage located in each State, and thus arrived at an estimate of the passenger fare attributable to each State. The actual net tax proceeds were then divided in proportion to the estimates of such passenger fare earnings.

In 1961, however, this Act was repealed and the passenger tax was abolished by merging it with the basic fares. It was however, decided to compensate the States through an *ad hoc* grant of Rs 12.65 crores p.a. which was the average of the actual tax collections during the two years 1958-59 and 1959-60. The Third Finance Commission recommended that the *ad hoc* grant be distributed on roughly the same principles as recommended by the Second Finance Commission. This step was followed by the recommendations of the Railway Convention Committee in 1965 according to which the States should

be given an annual grant of Rs 16.25 crores in lieu of the tax on railway passenger fares. Since then the States have been receiving this amount every year as the Railway Convention Committee in 1971 also made the same recommendations. Only actual shares of different States have been varying from year to year according to the calculation made under the given principle stated above. It goes without saying that had the tax on railway passenger fares continued, the actual earnings would not have remained stagnant. The States have been pressing the point and both the Sixth and the Seventh Finance Commissions accepted this argument, but since the Commissions were not authorized to enhance the amount of the grant under their terms of reference, they *suggested* that the Central Government should determine the amount of grant on the basis of what the tax amount would have been. However, even in 1980-81, the States continued to receive the same Rs 16.25 crores as in earlier years.

Grants-in-Aid*

Grants-in-aid of the revenues of the States are meant to meet their budgetary deficits. Such budgetary deficits, however, can be partly the result of extravagance in expenditure or insufficient effort at resource mobilisation. Care has to be taken, therefore, to ensure that States which are prudent in their financial administration and which try to increase their own resources are not penalized on this account and the States which have a less efficient financial management do not gain an advantage on account of this. In practice, however, it raises difficult questions and there is a feeling that the Finance Commissions have not been able to safeguard against this lapse. And the problem becomes still more complicated when it is realized that these grants are general and not conditional on their being used for specific purposes only.

Grants for Specific Purposes

Grants for specific purposes like Plan schemes and relief against drought, floods and famine etc., are made without reference to the Finance Commission. The presence of these conditional grants makes the situation a little more complex. For example, a State may be recommended a grant by the Finance Commission on account of a revenue deficit which is expected to occur if the State takes up projects for improving primary education and communications. The State, at the same time, may include these schemes

*Also *see* Chapter 15.

in its Plan programme, and get specific Plan grants through the recommendations of the Planning Commission and divert the grant money recommended by the Finance Commission to other uses. And in fact the States are known to have diverted the funds to uses other than those for which they were meant. The First Finance Commission was of the view that the States should be helped in their effort to build up certain administrative, social and economic services. It, therefore, recommended grants for raising the level of primary education to eight States in which the school enrolment was below the national average. The amount of these grants totalled Rs 900 lakhs for the four years 1953-54 to 1956-57.

But a clear-cut tendency to divert the funds to other purposes was noticed. It was clear that some form of supervision and check was needed to ensure that the grants made for specific purposes were not used for other purposes. The Second Finance Commission for want of such a check did not make any specific-purpose grant. The Third Finance Commission, however, revived the experiment by making specific grants of Rs 9 crores p.a. to 10 States for raising the level of communications. The States receiving these grants were: Andhra Pradesh Rs 50 lakhs; Assam Rs 75 lakhs; Bihar Rs 75 lakhs; Gujarat Rs 100 lakhs; Jammu and Kashmir Rs 50 lakhs; Kerala Rs 75 lakhs; Madhya Pradesh Rs 175 lakhs; Mysore Rs 50 lakhs; Orissa Rs 175 lakhs and Rajasthan Rs 75 lakhs. The Fourth and Fifth Finance Commissions did not make any specific-purpose grants because of the absence of necessary supervision, but the Sixth Finance Commission again revised that stand in the light of its explicitly stated bias to reduce regional disparities as far as possible. But it also wanted to ensure that the grant money was not diverted to other uses and so suggested a scheme of check against such a diversion.

The Sixth Finance Commission recommended that before making any Plan grants, the Government of India and the Planning Commission should verify if the Finance Commission had also sanctioned any grant for the same purpose such as for primary education, medical and public health, and welfare of Scheduled Castes, Scheduled Tribes and other backward classes. If it is found that the Finance Commission have provided a grant for any such purpose, then only that portion of expenditure should qualify for a Plan grant, which had not been taken into account by the Finance Commission.[13] For example, if expenditure for any specified purpose by a State is Rs 5

[13]Report of the Sixth Finance Commission, p. 68.

crores and the Finance Commission has recommended a grant on the basis of Rs 3 crores, the Planning Commission would determine the Plan grant with reference to only the remaining Rs 2 crores—unlike the earlier situation where the State could approach the Planning Commission and have a plan grant on the basis of the entire amount of Rs 5 crores

The terms of reference of the Seventh Finance Commission directed it to look into the requirements of States which are backward in general administration for upgrading of standards in non-developmental sectors and services with a view to bringing them to the levels obtaining in more advanced States The Commission chose to confine itself to some important elements in basic administrative infrastructure of government The Commission believed that Article 275 did not bar grants of capital sums Accordingly, the Commission recommended the sums indicated in Table 18 5 as

TABLE 18.5

SPECIFIC-PURPOSE GRANTS MADE BY THE SEVENTH FINANCE COMMISSION

(In lakhs of Rs)

States	*Towards Revenue Expenditure*	*Towards Capital Expenditure*	*Total*
Andhra Pradesh	401 77	1558 20	1959 97
Assam	497 97	1673 10	2171 06
Bihar	3675 43	2626 30	6301 73
Himachal Pradesh	561 02	212 80	773 82
Jammu and Kashmir	855 02	[illegible]72 80	1827 82
Kerala	28 56	89 10	417.66
Madhya Pradesh	5273 88	1083 95	6357 83
Manipur	91 57	903 80	995 37
Meghalaya		486 00	486 00
Nagaland	50 00	383 00	433 00
Orissa	2525 64	700 25	3225 89
Rajasthan	1252 41	677 05	1929.46
Sikkim		65.00	65.00
Tamil Nadu	1106 04	1614 60	2720 64
Tripura	137 51	223.36	360 86
Uttar Pradesh	8323 58	2878 20	11201 78
West Bengal	3[illegible] 26	2091 [illegible]0	2451 56
Total	25140 65	18538 80	43679 45

specific-purpose grants, subject to the implementation and monitoring of the schemes in the manner indicated by the Commission, for upgrading the standard of administration in the following non-developmental services:

(*i*) Judicial administration;
(*ii*) Revenue, district and tribal administration:
(*iii*) Police administration;
(*iv*) Jail administration;
(*v*) Stamps, registration and treasury administration.

General Purpose Grants

Coming to the general purpose grants which are meant to help the States in closing their budgetary deficits, the first step adopted is the re-estimation of the budgetary forecasts of the States. This re-estimation for determining budgetary needs was supplemented by the First Finance Commission by the following additional criteria, *viz.*, tax effort, economy in expenditure, standard of social services, special obligations and broad purposes of national importance. However, these additional criteria are not easy to quantify or even perceive in many cases. Thus a lower per capita tax revenue may be the result of general poverty of the people or lesser inequalities of income distribution. As yet no reliable method has been discovered to estimate the taxable capacity of any region or a country. Any judgement regarding whether a State has put in adequate tax effort or not would, by its very nature, remain a little vague and arbitrary, especially because the tax effort which a State *can* put in does not depend upon economic factors only. Various political, social and other factors come in. Similarly, there is no clear-cut basis of judging the existence or absence of the economy in public expenditure, though of course, no State Government should come to the conclusion that all its deficits, arising on whatever account, are to be met by the Government of India without any questions.

The First Finance Commission recommended the grants after taking into account the essential budgetary deficits, inclusive of the estimated receipts from sharing of income tax and Union excise duties as also the additional burden which some of the States had to bear on account of Partition of the country. It made an effort to ensure that the normal budgetary gaps of the States were met with and a reasonable margin for further expansion was also left. The annual grants recommended to various States by the First Finance Commission were the following:

Assam Rs 100 lakhs; Mysore Rs 40 lakhs; Orissa Rs 75 lakhs;

Punjab Rs 125 lakhs; Saurashtra Rs 40 lakhs; Travancore-Cochin Rs 45 lakhs and West Bengal Rs 80 lakhs. The remaining States, according to the Commission were not in need of any grants-in-aid of revenues. Thus, the general purpose grants recommended were of Rs 5.05 crores p.a. and the specific purpose grants for development of primary education varied from Rs 1.50 crores in 1953-54 to Rs 3.00 crores in 1956-57.

The Second Finance Commission, as stated earlier, did not make any specific purpose grants. But it took a more explicit note of the extra economic needs of the States arising out of the Plan activities. It interpreted the fiscal needs of a State in a comprehensive sense and maintained that the budgetary gap left after revenues from various sources including tax-sharing should be met by grants. In other words, grants were not to be a necessary part of the resources of a State but only a residuary item. But on account of the fact that the requirements of the States were increasing much faster than the resources available to them, the grants recommended were far bigger in comparison with what had been the case under the First Finance Commission The Second Commission also did not recommend grants for every State. Bombay, Madras and Uttar Pradesh were excluded and the eleven States got grants totalling Rs 187.75 crores for the five-year period (1957-58 to 1961-62). The shares of individual States were as follows· Andhra Pradesh Rs 20.00 crores; Assam Rs 20.25 crores; Bihar Rs 19.00 crores; Kerala Rs 8.75 crores; Madhya Pradesh Rs 15.00 crores; Mysore Rs 30.00 crores; Orissa Rs 16 75 crores; Punjab Rs 11.25 crores; Rajasthan Rs 12.50 crores, West Bengal Rs 19.25 crores; Jammu & Kashmir Rs 15.00 crores Total Rs 187.75 crores.

The Third Finance Commission maintained that though in principle it was correct to give due weightage to tax effort, financial prudence and level of efficiency of State administration, such a study could not be undertaken with the resources at the disposal of the Commission. It, however, as noted above, made special purpose grants to 10 States for the development of communications. These grants amounted to nearly 20% of the duty on motor spirit which had been left out of the duties to be shared with the States and maintained that the grants-in-aid should cover 75% of the *revenue component* of their five year Plans—a recommendation which was not acceptable to the Government of India on various grounds. The Plan is a flexible thing and subject to an annual review by the Planning Commission. It was considered preferable that the grants related to Plan be deter-

mined on the recommendations of the Planning Commission only. In the final analysis, in addition to the earlier mentioned specific-purpose grants for the development of communications, the annual grants-in-aid of the revenue of the States were:

Andhra Pradesh Rs 12.00 crores; Assam Rs 9.00 crores; Bihar Rs 8.00 crores; Gujarat Rs 9.50 crores; Jammu and Kashmir Rs 3.25 crores; Kerala Rs 8.50 crores; Madhya Pradesh Rs 6.25 crores; Madras Rs 8.00 crores; Mysore Rs 7.75 crores; Orissa Rs 16.00 crores; Punjab Rs 2.75 crores; Rajasthan Rs 8.75 crores; Uttar Pradesh Rs 2.00 crores; and West Bengal Rs 8.50 crores. Maharashtra did not ge any grant-in-aid of revenue. In addition to the above, under substantive provisos of Article 275(1) the following additional grants were made: Andhra Pradesh Rs 0.50 crore; Assam Rs 0.75 crore; Bihar Rs 0.75 crore; Gujarat Rs 1.00 crore; Jammu and Kashmir Rs 0.50 crore; Kerala Rs 0.75 crore; Madhya Pradesh Rs 1.75 crores; Mysore Rs 0.50 crore; Orissa Rs 1.75 crores and Rajasthan Rs 0.75 crore.

The Fourth Finance Commission took the view that without an effective supervision to ensure that the specific-purpose grants were used for the purposes they were made, such grants could not have a meaningful place in the transfer. However, the Fourth Commission also took a note of even those expenditure needs of the States which were not specifically mentioned in their terms of reference, such as the expenditure on account of servicing the State debt. Keeping in view the expenditure requirements and the possibilities of economy of expenditure they found that six States, *viz.*, Bihar, Gujarat, Maharashtra, Punjab, Uttar Pradesh and West Bengal would be having a revenue surplus and did not recommend grants for them. The remaining 10 States were recommended grants aggregating to Rs 121.89 crores p.a. distributed as follows:

Andhra Pradesh Rs 7.22 crores; Assam Rs 16.52 crores; Jammu and Kashmir Rs 6.57 crores; Kerala Rs 20.82 crores; Nagaland Rs 7.07 crores; Madras Rs 6.84 crores; Mysore Rs 18.24 crores; Madhya Pradesh Rs 2.70 crores; Orissa Rs 29.18 crores; Rajasthan Rs 6.73 crores.

The Fifth Finance Commission, like the Fourth Commission, also did not favour making any specific-purpose grants. Its terms of reference specifically excluded any recommendations for Plan grants, but it did include a consideration of the States' needs on revenue account, the interest charges in respect of their debt and the maintenance and upkeep of Plan schemes completed by the end of 1968-69

(when a project is completed, its recurring expenditure is transferred to revenue account). The terms of reference also required the Commission to consider, while recommending grants, the question of fiscal management so that wasteful expenditure could be avoided consistent with efficiency in administrative, maintenance, and developmental activities of the State. The Commission estimated the amortisation requirements for all the States at Rs 5966 crores. In addition, it noted the special problems faced by the States of Assam, Jammu and Kashmir and Nagaland and recommended bigger grants for them. It recommended grants for 10 States while seven States were left out on account of the fact that they were expected to have a surplus on revenue account. (We should remember that grants-in-aid on capital account were not within the competence of this Finance Commission). The eighth State, Mysore, was also expected to have a small surplus, but devolutions of taxes and grants to this State were coming to be less under the Fifth Finance Commission's recommendations as compared with what it got under the recommendations of the Fourth Commission. On this basis, Mysore was given a grant though of a comparatively smaller amount. The total grants, for five years, recommended to the ten States were as follows.

Andhra Pradesh Rs 65.01 crores; Assam Rs 101.97 crores; Jammu and Kashmir Rs 73.68 crores; Kerala Rs 49.67 crores; Mysore Rs 17.99 crores; Nagaland Rs 77.95 crores; Orissa Rs 104.67 crores; Rajasthan Rs 51.49 crores; Tamil Nadu Rs 22.82 crores; West Bengal Rs 72.62 crores; Total Rs 637.85 crores.

The terms of reference of the Sixth Finance Commission enjoined it to keep in mind the Central assistance for financing State Plans while recommending revenue grants. Furthermore, since the States had been pointing out their difficulties in maintenance of their capital assets in view of inadequate resources, the Commission was asked to take note of the expenditure arising out of the maintenance and upkeep of capital assets and maintenance of Plan schemes completed by the end of 1973-74. At the same time, other important items bearing on their expenditure commitments like the interest charges in respect of their debt, the requirements of certain States where there was a need to upgrade the general administration to bring it to the level of the administration in more advanced States in a period of 10 years were to be taken into account. It was also asked to make a general review of the debt position of the States with particular reference to the Central loans. Furthermore, in addition to the revenue resources available to the States from various sources the Commission was also to think of the possible economy in expenditure which was

possible without sacrificing efficiency. The Plan grants and the grants to be made under the provisions of Article 275(1) (referring to special grants for the States having tribal areas) were kept out of its purview.

The Sixth Finance Commission approached the whole question from the viewpoint of reducing the regional disparities as much as possible and this approach was clearly stated and emphasised by it. One result of this was the reopening of the question of specific-purpose grants. For this purpose, it identified certain administrative and social services like primary education, medical and public health and welfare of Scheduled Tribes and Scheduled Castes and backward areas, as to be of crucial importance and proposed that in a matter of five years, the standard of these services in the backward States should come up to the national average. But like the earlier Commission, it was also seized of the problem of adequate supervision by the Central Government to ensure that the funds of the grants made were not diverted to other uses. Accordingly, it did not make any specific-purpose grant. Instead, it suggested that the States should not be able to get Plan grants from the Centre against those expenditures which the Finance Commission had taken into account while recommending grants for specific purposes. The Sixth Finance Commission recommended grants-in-aid of revenue to 14 States (totals for five years 1974-75 to 1978-79) as follows:

Andhra Pradesh Rs 205.93 crores; Assam Rs 245.53 crores; Bihar Rs 106.28 crores; Himachal Pradesh Rs 160.96 crores, Jammu and Kashmir Rs 173.49 crores; Kerala Rs 208.93 crores; Manipur Rs 114.53 crores; Meghalaya Rs 74.76 crores; Nagaland Rs 128.84 crores; Orissa Rs 304.73 crores; Rajasthan Rs 230.53 crores; Tripura Rs 112.50 crores; Uttar Pradesh Rs 198.83 crores; West Bengal Rs 234.86 crores; Total Rs 2509.61 crores.

The terms of reference of the Seventh Finance Commission were on the same line as those of the Sixth Finance Commission The Seventh Commission was indirectly asked to lock into the non-capital needs of States by examining the maintenance cost of their capital assets. It was also asked to take into account the requirements of backward States for the purposes of upgrading standards of their administration in non-developmental sectors and services. To this end the Commission, as we have noted, made special-purpose grants.

Unlike the previous Commissions, this commission puts the Central Government forecasts also to a scrutiny which resulted in an overall improvement of Rs 4626 crores in the five-year period 1979-84. The Commission also adopted the approach "that the grants-in-

aid element in the transfer scheme should as far as possible be a residual item and the attempt should be to make the bulk of the transfers through tax shares"[14] This way, the States were able to share the benefits of buoyancy in the tax receipts of the Central Government and additional taxes raised by it. The Commission discussed the general principles which should govern determination of grants-in-aid of revenues of States. It took into account the tax effort of States and returns from their public undertakings at the stage of scrutiny of State forecasts, while according to one view the Commission should have considered these factors at the time of determining the amounts of grants by varying them in line with fiscal performance of individual States. Again, as usual, the Commission did not take into account the revenue of local bodies and their efforts to raise resources. It took prohibition as a national policy and recommended grants from the Centre to States to cover losses of excise revenue. It also recommended that net interest liability devolving on the States on account of their fresh borrowings and lendings should be made good by additional grants. The above-mentioned approach left eight States with gaps on the revenue account and the Commission recommended that a total of Rs 1173.12 crores of grants-in-aid be given to States as shown in Table 18.6.

General Comments on Grants-in-Aid

An important limitation of the system of making grants has been that every Finance Commission has tried to estimate and meet the

TABLE 18.6

GRANTS-IN-AID TO STATES IN 1979-84 AS RECOMMENDED BY THE SEVENTH FINANCE COMMISSION

(*Rs in crores*)

States	*1979-80*	*1980-81*	*1981-82*	*1982-83*	*1983-84*	*Total*
Himachal Pradesh	37.60	40 54	41.63	43.00	44.30	207.07
Jammu and Kashmir	41.06	40 82	39.20	39.40	39.08	199.56
Manipur	26.19	28.00	29 27	30.76	32.10	146.32
Meghalaya	16.97	17.67	18.44	19.48	20.05	92.61
Nagaland	38.29	41 34	43 65	46.48	48.59	218.35
Orissa	41.55	37.74	29 03	19.16	9.44	136.92
Sikkim	6.32	6.70	7.11	7.54	8.05	35.72
Tripura	24.36	25.75	27.29	28.85	30.32	136.57
Total	232.34	238.56	235.62	234.67	231.93	1173.12

[4]Report of the Seventh Finance Commission, Chapter IX, para 19.

budgetary gap on revenue account of the States. The estimates of revenue and expenditure provided by a State are scrutinized for obvious under or over-estimates for the purpose of standardisation, and the deficits or surpluses arrived at after taking into account the devolution of resources on account of tax-sharing. The philosophy is that the budgetary gap so arrived at is to be filled irrespective of the reasons for which it has arisen. However, it is obvious that a budgetary surplus or deficit is not simply a reflection of a State's needs in comparison with its resources. It is equally a result of financial prudence and an effort to mobilize tax revenues. A State which performs better than others on these two accounts loses in their comparison because its budgetary gap narrows down or vanishes. On the other hand, a State which shows less enthusiasm or concern for raising additional resources or avoiding wasteful expenditure automatically qualifies for bigger grants under this approach.

Even though the First Finance Commission realized that tax effort should be given a due weight in determining the grants for a State, this factor remained practically unaccounted for. In practice, the States which *did show* a better tax effort, were given smaller grants, and this fact remained established irrespective of the fact that tax effort cannot be measured very accurately on account of the non-measurability of taxable capacity. Actually, the Second Finance Commission just discarded the tax criterion totally. It observed "In our assessment of tax effort we have assumed that if a State raised additional revenue which it has promised for the Plan, it will have done its part."[15] The Third Finance Commission also refused to consider the tax effort because in its view the tax effort was intimately connected with the taxable capacity which it was not in a position to measure. The Fourth Finance Commission paid a lip service to the tax effort but maintained that the tax effort was related to the financing of the Plan expenditure only and was therefore, out of its purview. The Fifth Finance Commission, however, made an attempt to estimate the tax effort of each State by relating the incidence of total State tax to the per capita income. The Fifth Finance Commission was not asked to consider Plan expenditure in determining the grants. But for the remaining portion even it followed the same approach, namely, meeting the budgetary deficits. The approach of the Sixth Finance Commission has also been the same. It argued that reality of the situation did not favour the adoption of tax effort as a crite-

[15]Report of the Second Finance Commission, 1957, p. 64.

rion for grants. Such an approach was bound to "place at a disadvantage some of the States faced with big gaps on non-Plan revenue accounts. To leave such gaps uncovered on the ground of their tax performance, however defensible on theoretical considerations, would jeopardise maintenance of essential administrative and social services for want of adequate resources."[16]

Another observation that we can make in this connection is that the resources transferred on the recommendations of the Finance Commission form a smaller portion of the total as compared with the resources transferred through other channels. The Third, Fourth and Fifth Finance Commissions were barred from considering the non-capital gap of States for recommending grants-in-aid. Grants under provisos of Clause (l) of Article 275 have been kept out of the purview of the Finance Commission. Similarly, the discretionary grants for Plan and non-Plan purposes like the relief against natural calamities are handled directly by the Planning Commission or the Central Ministries concerned. To put it differently, the Finance

TABLE 18.7

RESOURCES TRANSFERRED FROM THE CENTRAL GOVERNMENT TO THE STATE GOVERNMENTS

(Rs in crores)

Period	*Resources transferred through*		*Other transfers*	*Total*
	Finance Commission	*Planning Commission*		
1951-52 to 1955-56	447	880	104	1431
1956-57 to 1960-61	918	1058	892	2868
1961-62 to 1965-66	1590	2738	1272	5600
1966-67 to 1968-69	1782	1917	1648	5347
1969-70 to 1973-74	5421	4731	4949	15101
1974-75 to 1978-79	10994	10051	4119	25164
1979-80 to (B. E)	3759	3558	747	7659
Grand Total	24911	24933	13731	8064

Source: Report of the Seventh Finance Commission and RBI Bulletin for September, 1979.

[16]Report of the Sixth Finance Commission, 1974, p. 52.

Commission's role has been quite a limited one, especially in view of the fact that due to economic and social developments, the transfer of resources without reference to the Finance Commission are far larger than the resources transferred on the recommendations of the Finance Commission. It is partly on account of this fact that the States have become highly indebted to the Centre and debt figures have increased rather phenomenally. Table 18.7 will indicate the relative amounts of resources transferred from the Centre to the States under the recommendations of the Finance Commission and otherwise. It is seen that the resources transferred through the Finance Commission are less than 40% of the total resources transferred.

Furthermore, the limited sphere over which the Finance Commission can operate has made its task far less effective in its own right. The fact that the grants and loan transfers made by the Centre under its discretionary powers have been very large make them both a source of strength and weakness to the system of resource transfers. On the side of weakness, it may be stated that the States lose quite a good deal of financial autonomy through such transfers. These loans and grants are mostly conditional and sometimes are given on the basis of matching contributions by the States. As a result, the schemes for which these transfers are made are closely scrutinized by the Centre or the Planning Commission It is claimed that the Central Government may not be able to judge the local priorities of various schemes, and therefore some such schemes may also be chosen which should be occupying a low priority. All these arguments lead to the suggestion that so far as possible, the States should be able to get larger resources through tax-sharing and statutory grants rather than through discretionary loans and grants. However, the strength of this system of resource transfer is that through the close scrutiny which it provides, it is possible for the Centre to keep the States near the national priorities and objectives than would otherwise be the case.

It is under this flexibility, for example, that the Central Government could provide in the past years important non-Plan grants to the States for improvement of roads, rehabilitations of displaced persons and as an incentive for higher procurement of foodgrains etc. We have other examples also. Need for adjustment is also found frequently in relation to the State Plan schemes financed with IDA/World Bank assistance. These agencies insist on incurring certain order of outlay within a specified period, thereby imposing an

additional burden on State budgets in the plan period whereas the external assistance accrues to the Central budget. Accordingly it was decided in 1975-76 to provide to the States an extra assistance in respect of the State Plan projects assisted by IDA/World Bank. The remaining amount of Central assistance is being currently allocated on the basis of lump sum allocations for some States and in accordance with the Gadgil formula for the remaining ones.

The States, it is alleged, have tried to get advantage of the division of responsibility between the Finance Commission and the Planning Commission to secure much larger Central assistance without commensurate tax efforts on their part. They would plead with the Planning Commission for larger-sized Plans under the promise of larger resource-raising effort. The Finance Commission would look at the situation in terms of a gap between the need and the corresponding revenue which the States should raise (or mostly, *were* raising). In any case, the States would emphasize the lower revenue potential of their resources vis-a-vis that of the Centre. This practice on the part of the States, therefore, obviously pointed towards a need for assessing the revenue potential of the States and their corresponding tax effort. The Planning Commission accordingly started making these estimates and suggesting to the States the desirability of the needed resource effort. These estimating methods are being improved and the Planning Commission has also adopted an incentive scheme under which 10% of the Plan assistance is assigned to those States whose tax efforts are above the expected level.

In this connection, there has been a difference of opinion, therefore, as to whether such a division of functions regarding the resource transfers from the Centre to the States is a desirable one, or whether there should be only one agency which should make the recommendations about all the transfers. In the earlier years of planning era, there was a certain extent of confusion also as to the relative jurisdiction of the Finance and Planning Commissions in recommending the grants, and this led to a division within the membership of the Third Finance Commission. The members other than the Member Secretary held the view that the Finance Commission was competent to recommend grants to the States to cover not only their non-Plan expenditure, but also the Plan expenditure. Accordingly, they recommended grants to cover, in addition to the non-Plan revenue expenditure, 75% of the revenue expenditure on Third Plan also. The Member Secretary, however, maintained that the grants given by the Planning Commission were conditional and tied to certain projects and programmes and provided an 'effective coordination of the States Plans,' especially

because these grants were subject to annual review. The Government of India accepted the Member Secretary's view point. Now the terms of reference of the Finance Commission specifically limit its grant recommending functions to only Article 275 excluding the provisos to Clause (1) of that Article.

The way our system of resource transfers from the Centre to States has worked is not entirely satisfactory. Some comments in this connection will be found in the Chapter on State Finances. The Seventh Finance Commission tried to remedy some of these defects. The earlier Finance Commissions used to underestimate the resource gaps of the States, but would fill the gap so underestimated through grants-in-aid without adjusting the grant amounts for fiscal prudence and resource mobilisation by States. The Commissions would allow only those expenses which were 'firmly committed' in the sense that orders for them had been actually issued. No consideration was given to the desirability or otherwise of these expenses. The States, therefore, got into the habit of running into these 'committed' expenses to the extent possible before the Commission was to submit its report. The Seventh Finance Commission tried to remedy this situation by choosing a bench-mark date (1 January 1977) with reference to which the committed expenses were to be allowed. However, this approach also failed to account for the desirability or otherwise of the expenditure items under consideration. The Seventh Finance Commission, however, was alive to reality in numerous ways. The earlier Finance Commissions were subjecting only State forecasts to an itemwise scrutiny and accepting the forecasts of the Union Finance Ministry as submitted. The Seventh Finance Commission subjected the resource forecasts of the Centre also to a scrutiny and found that resource availability had been underestimated by Rs 4626 crores for the period 1979-84. Similarly, the Commission tried to enhance the element of tax transfers in the total scheme of transfers. It accordingly increased the share of States in the proceeds of Union excise duties from 20% to 40%. The proceeds of the duty on generation of electricity were also assigned to States. The Commission tried to leave some surplus with States in the overall scheme of transfers.

However. it should be remembered that our Centre-State financial relations can work more satisfactorily only if both the Centre and States realise their responsibilities. The States must try to practise utmost financial discipline and raise resources. The Centre, on its part, should ensure that it is considerate to fiscal needs of the States. In the overall scheme of things, the indebtedness of States to the Centre must be reduced and transfers from the Centre to States for unproductive purposes must be in the form of grants rather than loans.

19 PUBLIC DEBT IN INDIA

In this chapter, we will not go into abstract theoretical questions connected with public debt such as the relative merits of financing public activities through debt or taxation and the like. Such questions have already been discussed earlier in a chapter. Here we shall confine ourselves to the nature, structure, and problems of the Indian public debt and the related issues. Though public debt can be defined broadly or narrowly depending upon the analytical purpose in hand, we shall not confine ourselves to any narrow definition here. Instead we shall look into broad categories of obligations of both the Central and State Governments and pick up the issues related to them for a brief discussion.

Debt Obligations of the Government of India

Let us begin by looking into the types of obligations of the Government of India. Let us first divide them into two parts—internal and external obligations External debt refers to loans raised outside India. Such loans may be payable in foreign currencies or in Indian rupees together with such interest and other terms and conditions as may be attached to these loans. In practice, it is possible that a part of these loans may come to be owned by Indian citizens themselves, but we shall ignore this possibility, as it is not very likely to occur, and because our external loans are almost exclusively from governments and institutions. Internal loans, similarly, may better be described as the ones raised in India. They are payable in rupees. Though here also it is possible that a part of such loans may be owned by foreigners, we shall ignore this possibility, especially since its actual incidence is very low.

Government of India can borrow, under Article 292 of the Constitution, upon the security of the Consolidated Fund of India within such limits, if any, as may be fixed by Parliament from time to time. Actually no such statutory limit has yet been fixed. The question of prescribing such limits has been engaging the attention of some thinkers, especially those who are not sure about the self-imposed financial discipline of the Government. The question was specifically raised by the Estimates Committee in their 20th Report, and by the Public Accounts Committee in their Report of April 1965. The

Committee appreciated the hesitancy and reluctance on the part of the Ministry of Finance in regard to fixing a limit by Parliament on public borrowings by the Government. But it still emphasised that the matter be reviewed every five years. As pointed out above, the desire to impose such a restriction upon the executive authority stems from the fear that the authorities would not observe strict financial discipline. But we must remember the other side of the picture also. Any statutory limit would spell an undue restriction upon the manoeuvrability of the authorities especially in view of an all round uncertainty which they face with regard to budgetary outcome and market circumstances. The position regarding external loans is always far more fluid since it equally depends upon international political situation. Under such circumstances, probably, it is best to have only indirect control by Parliament through discussions and debates. Accordingly the Ministry of Finance maintained that "in all circumstances the Government is satisfied that no real advantage would be secured by prescribing statutory limits on government borrowings "[1]

Before discussing the nature and structure of internal debt obligations of the Government of India, it will be helpful if we look into the mechanism by which currency is issued by the authorities to the public. In India, one-rupee notes and coins and coins of smaller denominations are minted and printed by the Government of India. They are, however, issued to the public only through the agency of the Reserve Bank of India. The Government of India 'sells' its notes and coins to the Reserve Bank which becomes indebted to the Government to an equivalent amount Similarly, the Government may sell its obligations (Treasury Bills and other securities) to the Reserve Bank in which case again the Bank will credit the Government accounts with the requisite amounts. When the Government spends out of these accounts, the Reserve Bank issues currency to the public (Government of India notes and coins and its own notes which are its obligations to pay to the holder of such notes) It must be noted that the ultimate obligation of the Reserve Bank of India is in terms of the Government of India notes and coins, and the Government's own non-currency obligations also run in terms of paying in its own currency and coins. Actually the Government of India can just print more currency notes and thus add to its capacity to meet other obligations, since according to the Union

[1]Ninth Report of the Public Accounts Committee, Third Lok Sabha, cited in the *Report of Public Accounts Committees, 1964-65*, New Delhi, Lok Sabha Secretariat, April 1965, p. 8.

List, currency and mint is a function reserved for the Central Government.

The Non-Currency Obligations of the Government of India may be divided into the following parts·

1. **External Debt.** *Firstly,* we have the category of External Debt which is the debt raised outside India. Under our Constitution, only the Central Government (and not the State Governments) can raise external loans. If foreign loans are meant for certain projects within the purview of a State Government, the Central Government gets those loans and relends them to the State. As a result, the State Government becomes a debtor to the Central Government which in turn becomes a debtor to the foreign lenders. Total external debt was Rs 32.03 crores at the end of 1950-51 and was budgeted to be Rs 10608 crores by the end of March 1981.

2. **Internal Debt.** Officially, the four categories enumerated below are collectively called the *Internal Debt.* This way, the loan categories 'Small Savings Schemes,' 'Other Unfunded Debt' and 'Reserve Funds and Deposits' are excluded from the definition of internal debt. Theoretically, of course, all loans raised within the country or owned by the Indians should be termed the internal debt.

(1) *Market Loans.* They may better be called dated loans, or funded loans, though they were once referred to as *Permanent Loans.* These loans have a maturity of 12 months or more at the time of issue The term funded loans is generally used when shorter-term obligations (such as treasury bills) are replaced by these longer maturity loans. For example, the Government of India has often 'funded' its treasury bills into longer-term loans. These market loans are generally interest-bearing—except when their date of repayment (or redemption) has arrived and the creditors are yet to come and collect their payments. This fact appears in the form of "Current Loans in Course of Repayment." Maturity-wise, these loans may be divided into two parts—non-terminable and terminable. Non-terminable loans, by definition, do not have any maturity date. The Government is not under obligation to pay the principle of these loans; it only pays the periodic coupon (or interest amount) that is falling due. In India, there are two such non-terminable loans. The first one was issued in 1896-97 and is called "3% Non-terminable Loan 1896-97" and has a face value of about Rs 8.93 crores. The second one is "3% Conversion Loan 1986 or Later." It was created in 1946 and has a face value of about Rs 248.92 crores. Other dated loans have a maturity ranging from three to thirty years at the time of issue. It is also obvious that the term to maturity of a terminable loan slides

towards zero with the passage of time. The Government has not only 'funded' treasury bills of varying amounts into 'permanent loans,' it has also been issuing additional tranches of the existing loans. Almost all these loans are *marketable*, though additional tranches of some loans were issued in favour of the Reserve Bank on a non-marketable basis. Also the Government of India took over some loan obligations of the erstwhile Hyderabad and Bhopal Governments which were not put in the marketable category.

(2) *Floating Debt*. The second main category of the 'internal debt' obligations may be termed floating debt. It, in turn, may consist of several component elements.

(*a*) *Ways and Means Advances*. These are short-term credits from the Reserve Bank of India meant for meeting temporary requirements of finance. Since 1943, however, the Government has not availed of this facility.

(*b*) *Treasury Deposit Receipts*. They were introduced on 15 October 1948 and were meant to meet the short-term financial requirements of the Government and to mop up the excess liquidity with the commercial banks. The Receipts carried a low rate of interest and were issued only to the commercial banks for maturities of six, nine and twelve months. These receipts were not discountable, but could be pre-encashed. They are now an extinct species; the last of them was seen in the mid-fifties. Their amount, however, was quite insignificant. At end-March 1951, for example, the outstanding Treasury Deposit Receipts were of the value of Rs 6.73 crores only.

(*c*) *Treasury Bills*. Currently floating debt exists only in the form of Treasury bills. They have a maturity of 13 weeks and are issued every Friday. They are issued at a discount and redeemed at par. Though at the end of March 1951 outstanding treasury bills were of the value of Rs 358.02 crores only, by end-March 1981, they were expected to increase to Rs 11242 crores. They are an important means of financing the budgetary deficit of the Government of India.

(3) *Special Floating Loans*. They comprise the non-negotiable, non-interest bearing securities issued to meet our obligations to international financial institutions like International Monetary Fund, the International Bank for Reconstruction and Development, International Development Association and Asian Development Bank. These loans were budgeted to have the value of Rs 2189 crores at the end of March 1981 and included non-negotiable non-interest bearing rupee securities for IMF (equivalent SDR of 1411.6m), for IBRD (equivalent of $101.997m) and for Asian Development Bank (equivalent of $58.82m).

(4) *Other Obligations*. There are primarily the *Compensation Bonds* outstanding on account of nationalisation of the major commercial banks and the Development Bonds and the like. The Compensation Bonds have a face value of Rs 102.30 crores. Other kinds of unfunded debt here would include the Prize Bonds which were loans with lottery features. Prize Bonds were first introduced in April 1960 and were expected to yield Rs 25 crores during the budget period 1960-61. But these Bonds did not catch popularity. The scheme yielded only Rs 15.6 crores in 1960-61 and Rs 3.3 crores in 1961-62 and as a result it was discontinued from 1 July 1962. It was replaced by another scheme of Premium Prize Bonds in 1963 with bonds of two denominations, namely, Rs 5 and Rs 100. The redemption values of the two bonds were fixed at Rs 5.50 and Rs 110 respectively and the holder was also entitled to prizes on a lottery basis. Even this scheme failed. The two prize bond schemes could collectively yield only Rs 26.47 crores.

The sum total of 'External Debt' and 'Internal Debt' as described above is officially given the name of *Public Debt* of the Government of India. Probably the reason for excluding borrowings in the form of small savings, provident funds etc., from the official definition of Public Debt is to distinguish between loans 'raised' with specified dates of payment etc. and loans 'contracted' in the process of various sovereign rights and duties.

3. **Small Savings**. An important form of non-funded debt is the *small savings*. They consist of 15-year Annuity Certificates, Post Office Saving Bank Deposits, Cumulative Time Deposits, Recurring Time Deposits, 12-Year National Defence Certificates, 10-Year Defence Deposit Certificates, Treasury Saving Deposit Certificates, National Savings Certificates, Fixed Deposit Scheme and the like. The sale of $3\frac{1}{2}\%$ Treasury Deposit Certificates was discontinued with effect from June 1957 and the sale of 4% Treasury Saving Deposit Certificates was discontinued with effect from June 1962. Though small savings stood at only Rs 336.87 crores at the end of 1950-51, they rose to Rs 6675 crores by March-end 1979 and the figure was expected to rise to Rs 7675 crores by end-March 1981. Since small savings are considered to be an important source of resource mobilisation and a helpful anti-inflationary measure, therefore, various efforts have been made to step up the collections of small savings. The rates of interest on various small savings have been raised. The States also have a direct interest in promoting the collections of small savings because 2/3 of the net small savings collections in each State are passed on to them in the form of 25-year loans. Furthermore, as an

incentive for mobilization of collections, for every 5% in excess of the national average of net to gross collections, the States are entitled to receive $2\frac{1}{2}$% over and above their normal share of 2/3 of the net collections. With effect from 1974-75, the State Governments are also entitled to loan assistance equivalent to 25% of the amount collected by way of personal collections over and above the target for personal collections fixed for that State.

4. **Other Unfunded Debt.** The debt obligations of the Government of India also include several other forms of unfunded debt. One category here is that of State Provident Funds which started from an outstanding amount of Rs 95.05 crores at the end of March 1951 and were expected to be Rs 2578 crores by end-March 1981. To this is now added the Public Provident Fund with an expected amount of Rs 213 crores by the end of 1980-81. The Public Provident Fund Scheme was framed under the Public Provident Fund Act, 1968 for the benefit of the general public. Deposits in a Public Provident Fund Account are repayable after 15 years from the end of the year in which that account is opened. The scheme provides facilities of loans and withdrawls from deposits made by subscribers. The maximum limit of deposits in a year is Rs 20,000 and the minimum limit is Rs 100. The interest rate charged on loans is only 1% p.a. The collections under this Scheme are also shared with the State Governments like small savings. There are also other items in 'other unfunded debt' (like special deposits of Non-Government Provident Funds) totalling to Rs 3249 crores at the end of 1980-81 (BE).

5. **Reserve Funds and Deposits.** These include various Reserve Funds pertaining to Posts and Telegraph, Railways and similar other items. Over the years this category has assumed a great importance as revealed by the figures in the accompanying table.

Debt Obligations of the State Governments

Like the Central Government, the State Governments also have a variety of debt obligations. The State Governments can borrow under Article 293 of the Constitution upon the security of their respective Consolidated Funds The State legistature may impose a limit from time to time within which a State Government can borrow or can give guarantees. A State can borrow only within the territory of India. Foreign loans can be contracted only by the Government of India. The Article further states that subject to the conditions, if any, which Article 292 might be imposing upon the Central Government, the Central Government can give loans to a State Government from the Consolidated Fund of India or can give

guarantees in respect of loans raised by a State. However, if a State is indebted to the Central Government, or if a loan guaranteed by the Central Government is outstanding, then the State Government can raise further loans only subject to such conditions as the Government of India may think fit to impose. Since every State Government is indebted to the Central Government, this provision of our Constitution means that no State can borrow without the permission of the Central Government. The Reserve Bank of India acts as the banker and agent for the debt operations of the States (as it does for the Central Government) so far as the market loans are concerned. The State Governments have the following main types of debt obligations in terms of older classification:

Firstly, there are the Permanent Loans. These loans are the counterparts of the permanent or funded marketable loans of the Government of India. *Secondly*, there is the Floating Debt which covers State Treasury Bills, ways and means advances, and overdrafts from the Reserve Bank of India. *Thirdly*, the most important category is the loans from the Central Government the servicing of which is causing a lot of hardship to the States We shall look into this problem later in this chapter. The State Governments also raise loans from the National Agricultural Credit (Long-Term Operations) Fund of the Reserve Bank of India, the National Cooperative Development Corporation and Life Insurance Corporation. Furthermore, there is the Unfunded Debt of which a major portion consists of the Provident Funds.

The above mentioned classification has been modified in accordance with the recommendations of the Second Report of the Team on Reforms in the Structure of Budget and Accounts. While in the older accounting, a distinction was made between permanent debt and floating debt, such is no longer the case now. The *new classification* has three main categories, namely Internal Debt, Loans and Advances from the Central Government, and Provident Funds etc.

1. **Internal Debt.** It consists of three portions namely:

(*a*) *Market Loans and Bonds* (which correspond to the old category of permanent loans). Of these, market loans are the dated loans raised from the market while 'Compensation and Other Bonds' correspond to old category of 'Floating Debt' except that from 1973 onwards, cash credits obtained/repaid during the year from/to State Bank of India and other commercial banks are excluded from here.

(*b*) *Ways and Means Advances* from the Reserve Bank of India. corresponds to the item 'other debt' in the older classification except that from 1973 ownards the item *includes* cash credits obtained/

repaid during the year from/to the State Bank of India and other commercial banks which were not included in the item 'other debt.'

(c) The third part is the *Loans from Banks and other Institutions.*

2. **Loans and Advances from the Central Government.** This category remains the same as in older classification.

3. **Provident Funds etc.** This category in the new classification corresponds to the item 'Unfunded Debt' in the older classification.

Indian Public Debt before 1951

To begin with, India's public debt was largely the result of war expenditure. As a result the Government was under debt of about £ 60 m by the time of uprising of 1857. The expenditure to suppress this uprising was also added to the public debt and the figure crossed £ 100 m by 1860. It was only later that the public debt was raised for development purposes like the building of railways and irrigation, and the debt backed by income-yielding assets started growing in comparison with the dead-weight debt.

The Indian Government was heavily relying upon debt raised outside India, partly under the belief that the Indian capital market was not able to invest sufficient funds in Government loans. As a result, at the beginning of the First World War in the 1914, the rupee debt of the Government stood at less than Rs 200 crores against the sterling debt of over Rs 265 crores. Even at the beginning of Second World War, in March 1939 sterling debt formed a major portion of the Indian public debt—Rs 469.10 crores against rupee debt of Rs 709.96 crores. The instrument of treasury bills had been introduced in 1917 to meet the short-term financial requirements during the First World War. The Second World War brought forth an ever-increasing need for the Government to borrow more on the home front; and at the same time, enabled it to pay off the sterling debt out of the accumulated export surpluses. In order to mop off additional liquidity in the country, and to raise funds for the war effort a vigorous campaign was launched which led to an increase in outstanding internal public debt from Rs 709.96 crores in 1939 to Rs 1936 crores in 1946. The war-time curbs on consumption and investment forced the surplus investible funds into Government loans in spite of a low rate of interest offered on them. Furthermore, this process was helped by the technique of offering a wide variety of public debt instruments to the public, and pressurising the institutional investors into investing in Government loans.

The War conditions, however, helped the country in paying-off its sterling debt which stood at Rs 469.10 crores at the end of March

1939 so that at the end of March 1946 it stood at Rs 37.69 crores only. There is a disagreement regarding the desirability of exact mechanism of repatriation of this debt. The Government was purchasing its own sterling debt in the open market and some people believe that we could save a few million pounds through a better planned policy. But irrespective of the merits of this argument, the fact and desirability of having repatriated so much of the sterling debt cannot be questioned especially in view of the comparatively higher rates of interest which we were paying on our sterling debt as compared with the interest that we could earn on our sterling balances. Another disadvantage mentioned in this repatriation is the inflationary pressures that it created in the Indian market. But it must be remembered that the war finance and activities were themselves creating inflationary pressures and the necessary steps to check them had to be taken by the Government in any case—only now they were being taken in a more intensified manner.

Indian Public Debt since 1951

Public Debt in India rose rapidly since Independence, but this time the major cause for such a rapid increase has been not the war requirements, but the need to raise funds for economic development. During the period, of course, our international political situation has not been very happy and we have had to incur heavy expenditure for defence purposes also. At the same time, our economy had to face large scale inflationary rise in prices leading to an unprecedented increase in administrative and project costs of the Government. Thus two opposite forces have been at work simultaneously. On the one hand, there is the need to raise additional resources both for development purposes and to syphon off excess purchasing power from the market; and on the other, the organised money market as such has not been able to spare enough of funds for investment in government loans due to more than one reasons (such as low rate of return on government loans). As a result we find that the non-marketable loans such as small savings, provident funds etc., have increased significantly and on the other, the funded marketable rupee loans have been mainly absorbed by the Reserve Bank of India, the Commercial banks, the Life Insurance Corporation and such like institutions only.

I. Nature and Issues—Central Government Debt

(1) *Reasons for Rapid Growth.* We find that since the introduction of planning in India, there has been a rapid increase in all kinds of

debt obligations of the Central Government. The reasons for such a development are not far to seek. The Government is faced with tremendous task of pulling the economy on to a rapid rate of economic growth for which raising the resources is the first pre-requisite. There is a need to build up various social overheads and what is called the infra-structure for economic growth. This involves establishing and developing a variety of industries, sources of raw materials and human sklls. It also involves a rapid development of certain basic economic and social facilities like those of transportation, communications and the like. Efforts at rapid industrialisation imply importing capital equipment and machinery which currently cannot be produced within the country. At the same time, increasing domestic requirements of food and raw materials and an inadequate or zero supply of various raw materials necessitate the importing of these items also. All told, the developmental efforts spell a large-scale import surplus. And to meet this deficit an inflow of external resources is needed. To the extent these external resources are obtained by way of foreign loans, our external indebtedness increases.

From Table 19.1 it will be seen that the outstanding external loans were only a nominal amount of Rs 32.03 crores at the end of 1950-51, but have since been increasing. The rate of growth of the external debt was somewhat slow in the beginning, but soon gathered momentum. By 1960-61, our external indebtedness stood at Rs 760.96 crores. The 1960's were a difficult period for us. Our import requirements increased at a fast rate and were supplemented by the increasing cost of debt servicing. By the end of the Third Plan, our external indebtedness had reached Rs 2590.62 crores. The process has continued and as a result the figure stood at Rs 5824.23 crores at the end of 1973-74. The estimate for the end of 1979-80 (RE) and 1980-81 (BE) are Rs 9899.20 crores and Rs 10607.91 crores respectively.

The external loans have helped our economy in a variety of ways, though they have not been an unmixed blessing. They have brought certain disadvantages also in their wake. On the benefits side, we may mention the availability of various kinds of machinery and equipment, technical skill and knowhow and our ability to establish and develop various new industrial and other projects. Foreign loans have been used for railways, roads, electricity generation, fertilizers, and so on. But as stated above, there have been certain disadvantages of these loans also. In a number of cases these loans were tied with our purchases and installation of machinery conforming to particular technologies. This has made us dependent upon certain imports while we

TABLE 19.1

DEBT LIABILITIES OF THE GOVERNMENT OF INDIA AT THE END OF . . . .

(*Rs in crores*)

Particulars	*1950-51*	*1960-61*	*1965-66*	*1973-74*	*1977-78*	*1979-80 R.E.*	*1980-81 B.E.*
I. Public Debt	2054.33	4738 96	8009.27	16931.38	28016.99	34738.21	39584 33
of which							
(A) Internal Debt	2022.30	3878.00	5418.65	11107.15	19032.25	24839.01	28976.42
of which							
(*i*) Market Loans—Current	1438.46	2555.72	3417.28	5851 45	9219.18	12830.04	15329.70
(*ii* Compensation & Other Bonds	...	19 80	15.13	86.74	125.20	150.14	176.63
(*iii*) Current Loans in course of ayment	6.49	23.73	33 72	54 19	50.48	47.30	47.30
(*iv*) Treasury Bills	358 02	1106 29	1611 82	4384 30	8618.83	10007.30	11242.30
(*v*) Special Floating Loans	212.60	274.18	340 70	730.47	1018 56	1804.23	2188.99
(B) External Debt†	32.03	760.96	2590.62	5824.23	8984 74	9899.20	10607 91
II. Small Savings Schemes	336.87	969.99	1538.21	3274.44	4902 82	6675.03	7675.03
III. Other Unfunded Debt*	111.15	551.37	1221.59	132..89	4236.72	5033.24	6040.46
of which							
(*a*) State Provident Funds	95.05	289.14	527.02	1119.40	1853.56	2342.39	2578.41
(*b*) Public Provident Funds	...	...	..	15.76	61.07	148.79	212.79
(*c*) Other Items	16.10	21.82	133.09	187.73	2322.09	2542.06	3249.26
IV. Reserve Funds and Deposits	363.05	283.92	560.05	2738.28	3054.38	3471.82	3581.28
of which							
(*a*) Bearing Interest	260.85	142.19	275.03	435.22	1236.40	1538.75	1652.86
(*b*) Not Bearing Interest	102.20	141.73	285.02	2303.06	1817.98	1879 07	1928.42

V. Total Liabilities	2865.40	6544.24	11329.12	24266.99	40210.91	49864.30	56899.60
Amount due from Pakistan on account of her share of pre-partition debt	300 00	300.00	300 00	300.00	300.00	300.00	300.00
Net Liabilities	2565.40	6244.24	11029.12	23966.90	39910 91	49564.30	56599.60

*Other than 15-year Annuity Certificates.

†Including oil credits.

Source: Explanatory Memorandum on the Budget of the Central Government for 1980-81, Statement VI.

had the alternative materials available. An example is that of fertilizers. Coal based fertilizers were commercially expensive in the 1960's and we agreed to have fertilizer plants which used naptha (a petroleum product) as the feed stock. This has imposed a heavy recurring import bill upon us. It is also claimed that heavy indebtedness to foreign countries is a source of economic drain for us as indicated in Table 19.2.

TABLE 19.2

EXTERNAL DEBT SERVICING

(*Rs in crores*)

	Amortisation	*Interest payments*	*Total debt servicing*
First Plan	10 5	13.3	23 8
Second Plan	55 2	64.2	119.4
Third Plan	305 6	237.0	542.6
Annual Plans	606.6	375 9	982.5
Fourth Plan	1584.2	860 8	2445 0
Fifth Plan			
1974-78	1941 7	946 6	2888 3
1978-79	609.1	290.6	899.7
1979-80	408.78	233.32	642.10
1980-81	410.40	230.54	640 94

Source: Economic Survey, 1978-79, and Explanatory Memorandum on the Central Government Budget for 1980-81

Starting from a figure of Rs 23.8 crores as external servicing for the entire First Plan period, the figure for the Second Plan, Third Plan, Annual Plans and Fourth Plan periods rose to respectively Rs 119.4 crores, Rs 542.6 crores, Rs 982.5 crores and Rs 2445.0 crores. The amount for the Fifth Plan was Rs 2888.3 crores and Rs 640.94 crores for the single year 1980-81 (BE). Such a heavy drain on account of external debt servicing reduces our economic manoeuvrability. With increasing import bill for petroleum products and a worldwide inflation, the situation is likely to worsen. It would be very helpful if through various measures we could reduce or eliminate our foreign indebtedness. As it is, our import requirements are on the increase. It is therefore necessary to develop and add to our export earnings if we want a relief on the front of foreign indebtedness.

Coming to the internal loans, we note that the Government needs huge resources for developmental and social purposes. It is not possi-

ble or desirable to raise all these resources through taxation only. During a given period, the authorities can raise additional resources through taxation only upto a limit. In the case of direct taxes excepting marginal adjustments here and there, the addition can be, by and large, on account of the buoyancy of the economy only. Indirect taxes have a greater scope, but in their case an excessive use may lead to inflationary pressures through raising the prices of taxed articles. Another reason put forth in favour of raising resources through loans is that they are expected to mop off excessive purchasing power in the hands of the public. Through loans the resources are just transferred from the public to the authorities and therefore no net addition to the purchasing power and hence demand takes place in the economy. This statement, however, needs a qualification. It is essential that these loans should be from "the market" and not from the Reserve Bank of India. In the latter case, loan financing adds to the money supply in the country and is therefore inflationary in character. Public debt in India has also increased rapidly due to the fact that the authorities have tried to tap all the sources and tailored the loans to the needs of the creditors. These loan instruments differ from each other in terms of maturity, marketability and other characteristics, as we have seen before. The result is that public debt has grown quite rapidly in all its components—though different components have grown at different rates. Thus long-term market loans have increased from Rs 1438.46 crores at the end of 1950-51 to Rs 15329.70 crores at the end of 1980-81 (BE). The most rapid rate of increase has been in the case of treasury bills which jumped from Rs 358.02 crores at the end of 1950-51 to Rs 11242 crores at the end of March 1981. Small savings have also a creditable record for which the corresponding figures are Rs 336.87 crores and Rs 7675.03 crores. Similar is the case with State Provident Funds which increased from Rs 95.05 crores to Rs 2578.41 crores during these years.

(2) ***Ownership Pattern.*** The pattern of ownership of public debt is an important and relevant factor in determining the burden on benefits of public debt (apart from its utilization). The ownership pattern is also directly related to the capacity of the authorities in pursuing proper debt management and monetary policies. In this connection, therefore, it is worth noting that as far as the permanent debt or funded rupee loans of the Government of India are concerned, a major portion (about 38% or so) is owned by the Reserve Bank of India. Holding of government securities enables the Reserve Bank of India to supply currency to the public (the need for which is increas-

ing with economic development and monetization etc.) and also is a precondition for any effective and successful open market operations. At the same time, however, an excessive holding of these securities means that these loans are not genuine market borrowings (transferring the excessive purchasing power from the public to the authorities). They are only a means of adding to the over all money supply in the country and are another form of borrowings from the Reserve Bank It must also be remembered that the permanent rupee debt is more or less institutionally owned Apart from the Reserve Bank, the other holders of this debt are the commercial banks, the Life Insurance Corporation, Provident Funds and the like. The general public does not find these loans attractive enough in terms of yield etc. The Government is often obliged to use various non-economic methods to force these securities upon a "captive market."

Treasury bills, which represent a major portion of the short-term borrowings by the Central Government, are almost wholly sold in favour of the Reserve Bank. Only some limited amounts are held by State Bank of India, other commercial banks, State Governments and other approved bodies. Treasury bills, therefore, represents deficit financing by the Government and cause a direct addition to the money supply with the public. They are highly inflationary if they are not retired.

We need not go into the ownership of Special Floating Loans which mainly comprise special securities issued to meet our obligations to various international institutions. But it is to be noted that other forms of government obligations, namely, small savings, State provident funds, public provident funds, deposits under Compulsory Deposit Schemes, Income Tax Annuity and other Deposits and Reserve Funds represent genuine savings by the public and certain commercial and other undertakings. The ownership pattern of these obligations is not only anti-inflationary, it is very helpful in mobilization of resources for public purposes.

(3) *Is Government of India Debt Burdensome?* A brief idea about the advantages and disadvantages of external debt has already been gathered a little earlier. It was pointed out there that foreign loans are helpful, but have certain disadvantages also. At the time of contracting of the loans, an inflow of resources takes place. Such an inflow will be advantageous to a longer or smaller extent depending upon the nature and composition of this inflow. At times, for example, the foreign loans can be for essential items of life like food, medicines, etc. At other times, they can be in the form of necessary raw materials, machinery, technical knowledge, skill and the like. In general, we may say that if the foreign loans are in terms of wasteful

consumption items, then they would not add to the productive capacity of the country. On the other hand, they may be very helpful in adding to the productive capacity of the debtor country. For the servicing of the foreign debt, an outflow of resources will be required. The burdensomeness of foreign loans will, therefore, depend upon the changes in the productive capacity of the country, and the terms and conditions of the foreign loans. In the case of India, we find that the burden of servicing the foreign loans has become very heavy, while our productive capacity has not increased proportionately. Moreover, in our case, our dependence upon maintenance imports has gone up, while the use of foreign loans has not enabled us to add to our export competitiveness to a significant extent. All told, therefore, we are finding it difficult to service the external loans.

Public debt becomes a dead-weight debt if it is wasted on consumption and other useless expenditure. However, unless the loans raised are specifically earmarked for particular projects and schemes, it is not possible to judge their effect and contribution to the economy in a straight-forward manner. In the absence of such a direct information, the next best method would be to analyse the outstanding liabilities of the Government with reference to the purpose on which the money raised by the Government has been utilized.

It will be seen from Table 19.3 that investments and other capital outlays were far below the liabilities of the Government at the end of 1950-51. Even at the end of 1960-61, the liabilities exceeded such capital outlays. But this situation was remedied during the Third Plan and at the end of 1965-66, the net liabilities were Rs 11029.12 crores against the capital outlays and loans of Rs 11964.23 crores. Since then the capital outlays and loans have increased at rates faster than the liabilities and according to the Budget Estimates for 1980-81, the corresponding figures of net liabilities and assets were Rs 56581.10 crores and Rs 58085.33 crores respectively. Of the outlays on departmental undertakings, the biggest share is claimed by railways. At the end of 1950-51, the next position was occupied by Posts and Telegraphs, but now Atomic Energy Development and Electricity Schemes are fast catching up. As regards the investments in autonomous corporations companies etc , we have a long list of giants like the Steel Authority of India, the Fertilizer Corporation of India, Oil and Natural Gas Commission, Heavy Engineering Corporation etc. Similarly, quite a few financial institutions have come up and are expected to be of help to the industrial and financial growth of the country. Thus we can conclude that by and large the Government debt has contributed to the potential of economic growth in the

TABLE 19.3

UTILIZATION OF MONEY RAISED BY THE GOVERNMENT OF INDIA AS AT THE END OF . . .

(*Rs in crores*)

Description	*1950-51*	*1960-61*	*1965-66*	*1973-74*	*1977-78*	*1979-80*	*1980-81*
A. Capital Outlay	1488 01	3590 21	6584 66	13150 31	21113 44	26039 90	29408 00
1. General Services	496 74	956 10	1700 61	3629 78	4188 38	5028 37	5972 14
(*i*) Defence Services	260 93	454 34	874 13	1992 56	2868 87	3385 16	3648 32
(*ii*) Other General Services	237 81	501 76	826 48	1636 22	1319 51	1643 21	2323 82
2. Social and Community Services	26 25	76 83	149 60	347 19	720 35	933 01	1090 30
3. Economic Services	965 02	557 28	4784 47	9173 34	16204 71	20078 52	22345 56
(*i*) General Economic Services	39 93	50 46	67 26	391 31	557 33	695 27	743 38
(*ii*) Agricultural and Allied Services	7 78	140 14	142 39	146 31	941 60	1440 21	1784 89
(*iii*) Industry and Minerals	34 34	579 31	1409 07	3405 34	6769 19	8378 11	9229 54
(*iv*) Water and Power Development	5 59	40 92	62 80	441 07	890 09	1395 21	1766 67
(*v*) Transport and Communication	878 40	1746 45	3082 93	3814 04	7046.48	8169 72	8821 08
(*a*) Railways	815 95	1512 57	2672 04	3105 00	4831 10	5589.59	5963.59
(*b*) Postal Services	49 98	139 99	264 98	205.77	574.19	617.83	681.13
(*c*) Other Transport & Communication	12 47	93 89	145 93	503 27	1640 89	1962.30	2176 36
B. Loans advanced by the Central Government	220 68	2534 48	5379 57	12495 97	19786.92	26554.16	28677.33
(*i*) State Governments	195 58	1909 63	3970 57	8569 70	11498 49	15711 24	16534 48
(*ii*) Union Territory Governments	..	...	40 61	73.28	179.22	291.70	351 35
(*iii*) Foreign Governments	0 01	29.17	27 65	108.42	337 24	276.13	336 98
(*iv*) Public Sector Enterprises etc.*	24 58	590 36	1329 11	3669.56	7648.12	10056.11	11244 94

(*v*) Government Servants	0.51	5.32	11.63	75.01	123.85	218.98	209.38
Total of Capital Outlay & Loans Advanced by the Central Government	1708.69	6124.69	11964.23	25646.28	40900.36	52594.06	58085.33
Total Net Liabilities	2565.40	6244.24	11029.12	24266.99	39910.91	49564.30	56581.10

Sources: Explanatory Memorandum on the Budget of the Central Government 1980-81.

*Include public sector enterprises, Railway Development and Revenue Reserve Funds, P & T, Port Trusts, Municipalities and Statutory Bodies, Cooperative and Educational Institutions, etc.

country. The real defect, if any, lies in the inefficient working and losses of the public enterprises as such.

The public debt policy of the Government has been successful at least in some directions. It goes to the credit of the Government that within such a short period, public debt has increased so much and contributed to the resource availability to the Government for Plan and non-Plan purposes. This is all the more creditable in view of the limited sphere of organised money market, an all-round scarcity of funds and competing claims for those funds by both public and private sectors. It is, therefore, a creditable development, that along with the dated loans, quite a good contribution has been made by small savings, provident funds, civil deposits and the like.

In spite of these meritorious aspects, the public debt front has exhibited certain weaknesses also. The rate of return on public debt has been quite low. Though this has helped the Government in keeping the interest cost in check, it has prevented the expansion of the government securities market. As it is, the government securities market is nicknamed a 'captive market.' Various institutional investors are directly or indirectly compelled to invest in government securities. Borrowing through treasury bills is more or less confined to the Reserve Bank of India and there is no market worth the name in treasury bills. Similarly, the provident funds and commercial banks are compelled to invest in government securities, with the result that dated securities of the Government of India are confined to the Reserve Bank of India, the commercial banks, the Life Insurance Corporation, the provident funds and other institutions. This phenomenon has added to the inflationary pressures in the economy which in their turn make the investment in government securities and small savings still less attractive. It is partly for this reason that constant efforts have to be made to encourage savings, e.g., through tax concessions long-term savings and higher interest rates on saving. For public debt policy to be anti-inflationary, contributions to the public debt should come from genuine savings and should add to the productive capacity of the country.

II. Nature and Issues—State Governments Debt

We have already briefly looked into various types of debt obligations which the State Governments contract. Tables 19.4 and 19.5 indicate the manner in which different components of States debt have grown since the commencement of Planning. It would be recalled that the classification of States' debt has undergone a modification because of which the relevant data are being presented in two tables.

TABLE 19.4

DEBT POSITION OF STATES AS AT END-MARCH . . . .

(*Rs in crores*)

	1952	*1956*	*1961*	*1966*	*1967*	*1968*	*1969*
I. Public Debt	390.20	1210.08	2605.98	5281 14	5863.92	6466.67	6988.95
	(86.9)	(93.3)	(95.1)	(95.8)	(95.8)	(95.6)	(95.1)
(*i*) Permanent Debt	134.02	257.17	500.02	827.14	910.85	985.93	1046.62
	(29.9)	(19.8)	(18.2)	(15.0)	(14.9)	(14.6)	(14.2)
of which Loans from the Market	131.43	222.44	409.93	719.84	821.29	890.77	958.54
	(28.2)	(17 2)	(14 96)	(13.1)	(13.4)	(13.2)	(13 0)
(*ii*) Floating Debt	15.70	10.28	41.74	189.26	75.34	102.52	241.49
	(3 4)	(0.8)	(1.5)	(3 4)	(1.2)	(1.5)	(3.3)
(*iii*) Loans from the Central Government	240.48	942 63	2013.99	4102.87	4703.29	5190.19	5499.89
	(53.6)	(72 7)	(73 5)	(74.4)	(76.8)	(76.7	(74.8)
(*iv*) Other Debt	—	—	50.24	161.87	174 44	188.03	210.05
			(1.8)	(2.9)	(2.8)	(2 8)	(2.7)
II. Unfunded Debt	58.46	86 48	133.45	230 64	260 20	300.43	359.88
	(13 1)	(6 7)	(4 9)	(4 2)	(4.2)	(4.4)	(1.9)
of which State Provident Funds	40 73	65.42	112.82	200 35	226.56	262.53	317.00
	(9.8)	(4 0)	(4.1)	(3.6)	(3.7)	(3.9)	(4.3)
Gross Total Debt	448 66	1296 56	2739.43	5511 78	6124 12	6767.10	7348.83

Note: Figure in brackets are the percentage to Gross Total Debt.

Source: Reserve Bank of India, Report on Currency and Finance, 1969-70, Statement 72.

TABLE 19 5

DEBT POSITION OF STATES AS AT END-MARCH .

(Rs in crores)

	1961	1966	1969	1971	1974	1975	1976	1977	1978	1979	1980
I Internal Debt	592	1178	1489	1847	2143	2404	2758	2948	3287	3291	3552
	(21 6)	(21 3)	(20 2)	(21 1)	(18 5)	(19 2)	(20 3)	(20 0)	(20 0)	(17 2)	(17 0)
(a) Market Loans and Bonds	500	827	1047	1233	1625	1840	2112	2293	2475	2653	2880
	(18 3)	(15 0)	(14 1)	(14 1)	(14 0)	(15 5)	(15 5)	(15 6)	(15 1)	(14 0)	(13 7)
(i) Market Loans	410	720	950	1143	1543	1761	2034	2216	2399	2577	2798
	(15 0)	(13 1)	(12 8)	(13 1)	(13 3)	(14 0)	(15 0)	(15 1)	(14 6)	(13 6)	(13 3)
(ii Compensation and Other Bonds	90	107	97	90	82	79	78	77	76	76	82
	(3 3)	(1 9)	(1 3)	(1 0)	(0 7)	(0 6)	(0 6)	(0 5)	(0 5)	0 4)	(0 4)
(b) Ways and Means Advance from the Reserve Bank of India	42	187	241	375	183	159	151	68	236	—	—
	(1 5)	(3 4)	(3 2)	(4 3)	(1 6)	(1 2)	(1 2)	(0 5)	(1 5)		
(c) Loans from Banks and Institutions	50	162	201	239	335	405	495	587	576	638	672
	(1 8)	(2 9)	(2 7)	(2 7)	(2 9)	(3 2)	(3 6)	(4 0)	(3 5)	(3 4)	(3 2)
II Loans and Advances from the Central Government	2014	4110	5584	6365	8579	9148	9681	10408	11529	13819	15336
	(73 5)	(74 5)	(75 1)	(72 8)	(74 2)	(73 0)	(71 3)	(70.8)	(70 3)	(72 7)	(13 0)
III Provident Funds etc	133	231	367	537	853	993	1142	1343	1568	1853	2145
of which	(4 9)	(4 2)	(4 9)	(6 1)	(7 4)	(7 9)	(8 4)	(9 1)	(9 6)	(9 8)	(10 2)

State Provident Funds	113	200	324	471	765	890	1022	1198	1389	1635	1888
	(4.1)	(3.6)	(4.4)	(5 4)	(6 6)	(7.1)	(7.5)	(8.1)	(8.5)	(8.6)	(9.0)
IV. Total Debt	2739	5519	7440	8749	11580	12545	13581	14699	16384	18963	21033

Note: Figures in brackets are percentages of Total Debt On account of certain classificatory changes figures after 1973 are not strictly comparable with those of earlier years.

Source: Reserve Bank of India Bulletin, September 1974, Report on Currency and Finance, 1975-76, 1976-77, 1978-79 and Report of the Seventh Finance Commission.

The comparative description of the two classifications has already been seen by us.

It would be noted that the aggregate liabilities of the States have increased at a rapid rate from Rs 449 crores as at the end of March 1952 to Rs 21033 crores as at the end of March 1980 BE. This is nearly 42 times the base period figure. Another peculiarity of the State debt is that almost all the components have remained, proportionately, more or less stable. The market loans form a small proportion of the State loans, and the State Provident Funds are still smaller though they are showing a steady increase both in absolute terms and as a proportion of the total State debt.

It would be noticed that the States have not relied sufficiently upon market borrowings and instead have become increasingly indebted to the Central Government. Both these phenomena partly stem from insufficient financial discipline on the part of the State Governments. Three points may be noted in this connection

Firstly, the cost of collection of tax revenue by the States has been proportionately higher than is the case with the Central Government. This implies a greater need to increase tax revenue

Secondly, the State Governments have not been able to tap their potential tax resources to the full. Instead the States claim that they are left with inelastic sources of revenue. This claim is not exactly justified. The States get a share from the most elastic sources of Central revenues, namely, income tax and excise duties. Sales tax, which is a State subject is highly elastic with reference to the economic activities and is in fact a good source of State revenue. But the States have not tapped quite a few potential tax resources like agricultural incomes.

Thirdly, quite a sizeable chunk of State resources has found its way in investments in State Electricity Boards, Irrigation Schemes and the like. These Schemes and investments should have opened up very important sources of State revenues but instead of throwing up surpluses, these projects and schemes are mostly incurring losses and are therefore a drain upon the State resources. The Sixth Finance Commission observed: "There are electricity projects that are unable to provide even for depreciation. There are irrigation projects, receipts from which are inadequate to meet even the cost of maintenance. There are many industrial enterprises which incur losses. There is practically no State in which the returns from productive schemes are large enough to provide for both payments of interest and amortiza-

tion."[2] The Seventh Finance Commission found that the situation in this regard had further worsened. The Report of the Commission provides extensive data in support of this view. (Of course, the performance of the undertakings of the Central Government is no better.)

However the need to borrow on the part of the States is not accompanied by their capacity to borrow. Like the Central loans, the State loans also carry a low coupan (though higher than the ones on Central loans). These yields are not attractive enough for the investors. The Central Government has been able to have a 'captive market' at its disposal. It sells the treasury bills to the Reserve Bank and compels banks, provident funds and other financial institutions to subscribe to the dated loans. In view of the general scarcity of funds and a competitive demand from other sources, people are not attracted towards State loans. A major portion of subscription to dated loans of the State Governments comes from those individuals and parties who are 'persuaded' by local bureaucrats to this end. Even the Reserve Bank of India's holdings of the State loans are nearly zero. Thus on the one hand, the State Governments find their needs soaring high and on the other they find that neither their investments income nor their tax resources are growing at adequate rates. They are also not able to borrow sufficiently from the market. As a result, we note that their dependence upon resources from the Centre has been increasing.

The States obtain resources from the Central Government in a variety of ways. They share with the Centre the excise duties and income tax and get a grant in lieu of the tax on railway passenger fares. The net proceeds of additional excise duties go fully to the States. They also get revenue grants from the Centre under Article 275 on the recommendation of the Finance Commission. But all this still leaves a large gap as far as Plan schemes are concerned. The States have also found it difficult to maintain their capital assets and meet the requirements of various relief measures against floods, droughts and diseases. The Centre has been extending discretionary grants and loans for meeting relief needs etc., under Articles 282 and 293 of the Constitution. But when it comes to granting aid for approved Plan schemes, the practice of the Central Government has been to help the States by giving them 30% of the aid by way of grants and 70% by way of loans (in the case of Assam and Jammu and Kashmir, the percentages are 90 and 10 for grants and loans respec-

[2]Report of the Sixth Finance Commission, para 6 of Chapter XVII.

tively). It is not easy to justify this or any other ratio between grants and loans through which the Central Government helps the States. As a matter of fact any arbitrary ratio could be chosen. Furthermore, it can be argued that a fixed ratio between grants and loans for helping the States ignores the relative financial strength of the States (though of course to measure their relative strength again raises a host of questions like those faced in the recommendation of grants-in-aid of revenues). It is also worth noting that the grants-in-aid of revenues recommended by the Finance Commission are meant to meet the non-Plan revenue gaps of the States without any reward for the tax efforts and financial prudence. A State excelling in financial discipline only loses revenue grants and remains equally dependent upon the Centre for aid as far as Plan requirements are concerned. This is an important reason due to which even those States which are not given grants by the Finance Commission run into increasing indebtedness to the Centre and find it equally difficult to service those loans. This difficulty increases all the more if the projects for which loans have been raised are non-productive (such as relief measures), or cannot yield commercial surpluses (such as electricity boards).

The Central Government gives loans to the State Governments for both Plan and non-Plan schemes. The Plan loans cover a variety of schemes which may be State or Central schemes. The non-Plan loans are meant to help the States in providing relief against natural calamities like floods, droughts, epidemics etc. and purchase of fertilizers. As we have seen earlier, the States get a share of collections of small savings also by way of loans from the Central Government. The loans from the Central Government to the States have been for a variety of purposes and at varying terms and conditions. There have been loans for relief and rehabilitation, for clearance of overdrafts in which the States have been running, for helping the States to meet their gaps in resources, for modernizing police force, for police housing and so on. The loans for meeting the Plan needs form the bulk of Central loans. All told, there has been a bewildering variety of loans and there is a need to codify them. The complexity of the problem and the need of a solution of the mounting debt liability of the States has been noted and voiced from time to time. The Third Finance Commission noted the gravity of the situation and recommended an analysis and review of the situation.[3] The Fourth Finance Commission felt that instead of a uniform treatment meted out to every State, a more thorough and

[3]Report of the Third Finance Commission, 1961, p. 42.

discriminating approach was needed with regard to periods, rates of interest and other terms of each loan which the Centre advanced to a State.[4] Incidentally, such a policy would have added to the mounting variety of loans and their terms and conditions. The Fifth Finance Commission suggested that those loans which did not bring direct returns should be kept within reasonable proportion of the States' own resources. But at the same time, on the recommendations of the Fifth Commission, the Centre started a scheme in 1969-70 to give special aid by way of loans to those States which (in view of the Planning Commission) were facing an inescapable resource gap in the Fourth Plan. The Sixth Finance Commission recommended that instead of giving large loans to States to meet natural calamities, they should get a larger aid for development of drought and flood prone areas. Such schemes could be both in the State and Central sectors and would reduce the necessity to grant loans to the States. It also recommended that the scheme of special loans to States for covering their non-Plan gap be discontinued. As a result, the Government of India Budget for 1974-75 made no provision under this head whereas in 1973-74, a loan of Rs 381 crores was given to States for this purpose. In 1974-75, total gross loans of Rs 1075.2 crores were extended to the States as against Rs 1576 crores provided in 1973-74. The figure rose to Rs 1294.3 crores in 1975-76 and reached the budgeted amount of Rs 2796.09 crores for 1980-81 BE. The general practice of fixing the interest charges prior to 1 April 1969 was to determine the rate of interest with reference to the prevailing redemption yields of Government of India loans with corresponding unexpired terms to maturity and add to it about $\frac{1}{8}\%$ by way of handling and other expenses. But if the loans were meant for specific purposes for relending to industrial and commercial undertakings by the States, then the interest rates charged by the Central Government were the same as were determined on the loans advanced by the Centre to Central public sector undertakings. The Fifth Finance Commission wanted a relief to the States in terms of their interest liabilities and accordingly, all these rates were reduced with effect from 1 April 1969. The maximum rate was fixed at only 5% with a rebate of $\frac{1}{4}\%$ for prompt repayment. Another change introduced was that recoveries of loans were put in *equal* annual instalments of due interest and principal. Prior to this arrangement, annual instalments consisted of given amounts of principal together with due interest. The Sixth Finance Commission recommended that the existing out-

[4]Report of the Fourth Finance Commission, 1965. p. 67.

standing loans should be consolidated into certain specific categories and the terms of repayment should be liberalized. Accordingly, the Central Government rescheduled the payment of block loans for State Plans, special accommodation loans, loans for relief against natural calamities, loans for clearing overdrafts and loans for specified development schemes. These loans became repayable between 15 to 30 years and some of them carried a moratorium towards repayment ranging from 2 to 5 years for certain States. Again in the case of loans for relief and rehabilitation and loans under the National Loans Scholarship Scheme outstanding as on 31 March 1974 the States were to repay only half of the amounts collected from the borrowers.

As the Sixth Finance Commission noted, a large debt by itself is not a sign of weakness of a State or a phenomenon to be worried about. The problem becomes serious because these loans have not been able to add to the revenues of the States and augment their repaying capacity. The Sixth Finance Commission estimated that the total outstanding loans from the Centre to States as on 31 March 1974 were Rs 8379.97 crores (of which Rs 3239.64 crores were non-developmental loans and Rs 5140.33 crores were developmental loans). The amount falling due for repayment during 1974-75 to 1978-79 was estimated to be Rs 3899 03 crores (Rs 1822.57 crores for non-developmental and Rs 2076.46 crores for developmental loans). The Seventh Finance Commission found that the assets of the States (comprising of capital outlay and outstanding loans of the States to others) always exceeded the total debt liability of the States (See Table 19.6). The Commission did not favour the idea of writing off these loans since such a step would have left the Central Government with smaller funds to help the relatively backward States. The Commission maintained that these loans should be considered like a revolving fund available to the economy as a whole and therefore the beneficiary States should repay these loans in order that others should be helped. The Seventh Finance Commission also took the stand that it was not desirable to write off the States' debt to the Centre. But both Commissions felt the need to provide relief to the States. The Sixth Finance Commission recommended a relief on discriminatory basis between Plan and non-Plan loan as shown in Table 19.7. The Seventh Finance Commission agreed with the plea that loans on account of small savings should be converted into 'loans in perpetuity.' Accordingly, they recommended that in the case of each State the small savings loans outstanding against the State at the end of March 1979 be consolidated into one loan, and such consolidated

loans be converted into 'loans in perpetuity.' The States would not be repaying their principal, but would continue to pay interest on these loans. The Commission divided the remaining loans into three categories, namely, unproductive, semi-productive and productive. It recommended that unproductive loans (Rs 842.82 crores) as on

TABLE 19.6

LIABILITIES AND ASSETS OF THE STATES AS AT END MARCH . . .

(Rs in crores)

	1951	*1956*	*1961*	*1966*	*1969*	*1974*	*1979 (estimated)*
Assets							
Capital Outlay	369	1135	2365	4281	5743	9330	17362
Loans Outstanding	93	309	846	2246	3197	5163	9511
Total	462	1444	3211	6527	8940	14493	26873
Total Debt Liability	375	1296	2739	5512	7425	11590	18785

Source: Report of the Seventh Finance Commission.

31 March 1979 be written off. The semi-productive loans were to be recovered in to 30 equal annual instalments and bear 4.75% rate of interest while the productive loans were to be recovered in 15 equal annual instalments and bear 5% rate of interest. The net debt relief to each State is shown in Table 19.7.

Such a relief measure, we should remember, is not a lasting solution of the problem. The very fact that the problem has arisen indicates that the States are not tapping their resources to the extent they can. There is therefore a need for a comprehensive financial discipline—economy in expenditure, avoidance of wasteful and unnecessary schemes and a vigorous drive to tap all the potential resources. There is equally a need to make the commercial projects pay their way through and provide a source of surplus to the State economies. Unless, therefore, an all-round effort is made, the problems of Central loans and overdrafts from the Reserve Bank of India are likely to persist. Loans have had a dominating position in the resource transfers from the Centre to the States. Till 1973-74, they tended to be as large as shared taxes and grants put together. Even in 1979-80, they were around 28% of the total. The real defect in the whole situation is that a large portion of these loans goes to service and repay the older debts.

TABLE 19.7

AGGREGATE DEBT RELIEF TO THE STATE

(Rs in crores)

	By Sixth Finance Commission				*By Seventh Finance Commission*
	Non-plan	*Specific purpose plan loans*	*Other loans*	*Aggregate debt relief*	
Andhra Pradesh	31.99	19.11	140.10	191.20	135.63
Assam	24.78	5.72	131.99	162.49	112.20
Bihar	10.18	19.47	103.10	133.35	182.65
Gujarat	1.25	14.29	20.71	36.25	108.02
Haryana	10.20	3.82	19.12	33.14	38.29
Himachal Pradesh	0.04	0.99	33.54	34.57	30.37
Jammu & Kashmir	16.09	1.24	116.10	133.43	133.79
Karnataka	29.35	15.39	82.30	127.04	39.53
Kerala	26.12	11.69	71.96	109.77	115.09
Madhya Pradesh	0.71	14.62	71.83	87.16	147.34
Maharashtra	2.00	23.81	40.77	66.58	160.78
Manipur	0.04	0.24	14.95	15.23	11.85
Meghalaya	0.01	...	7.63	7.64	5.94
Nagaland	...	0.24	5.60	5.84	18.59
Orissa	2.54	10.16	144.62	157.32	96.48
Punjab	0.30	4.53	10.35	15.18	60.57
Rajasthan	44.29	8.00	205.85	258.14	137.98
Sikkim	--	—	—	—	0.66
Tamil Nadu	28 98	20.95	37.12	87.05	49.93
Tripura	—0.02	—0.10	14.47	14.35	10 55
Uttar Pradesh	18.67	29.39	102.71	150.77	367.63
West Bengal	19.36	13.51	110.25	143.12	191.93
Total	266.88	217.07	1485.67	1969.62	2155.80

Source: Reports of the Sixth and Seventh Finance Commissions.

20 GOVERNMENT OF INDIA FINANCES

INTRODUCTION

Though there has been a continuous upward trend in both revenue and expenditure of the Government of India, it has been especially marked since Independence. Quite a few factors which we noted in the chapter on budgetary policy and in the explanation of a continuous upward trend in the public expenditure, are in operation in our country also. The Government has been widening its activities in economic and social spheres and is trying to help the country in its economic growth. It has expanded its social and economic responsibilities. Administrative services have been strengthened, social and economic services have been expanded and the Government is participating in an ever-increasing measure in the capital formation, savings and investment and other economic activities Also on account of increasing prices, the cost of administration has increased. All this has meant a steady upward movement in the Government of India budget from year to year.

The Central Government Budget is presented (and our Constitution requires it to be so) in terms of a revenue account and a capital account. Capital account is expected to cover those receipts and disbursements which are in the nature of acquisition, creation and disposal etc., of assets including investments, loans and advances. Receipts of routine nature and earnings from assets in the form of interest, dividends, profits and the like belong to the revenue account, as do the debt services, grants and others. Further, railway budget is presented separately before Parliament, though the total receipts from and expenditure on railways are included in the main budget as well.

Table 20.1 indicates a general picture of how Government of India revenue and expenditure have increased rapidly since we embarked upon a planned era. It will be seen that the receipts on revenue account have increased by about thirty times during the years 1950-51 to 1980-81, while expenditure on revenue account has jumped up by more than 39 times during the same period. Actually, revenue budget figures for the single year 1980-81 are more than five times the total revenue budget figures for the First Plan as a

TABLE 20 1

OVERALL BUDGETARY POSITION—GOVERNMENT OF INDIA

(Rs in crores)

	1950-51	First Plan	Second Plan	Third Plan	Annual Plans	Fourth Plan	Fifth Plan 1974-78	1978-79	1979-80 R.E.	1980-81** B.E.
Revenue Account										
Receipts*	405.86	2232.45	3562.87	8711.44	7786.73	20087.87	33163.41	11239.93	11176.83	12127.31
Expenditure	346.64	1982.97	3342.87	7691.99	7373.02	19677.15	30784.59	10947.62	12047.53	13568.57
Balance	+59.22	+249.48	+220.00	+1019.45	+413.71	+410.72	+2378.82	+292.31	−870.70	−1441.26
Capital Account										
Receipts	104.45	1053.58	3075.82	6795.73	6801.88	11856.62	17014.93	6285.05	5447.05	8430.12
Disbursement	182.59	1698.06	4231.82	8587.43	8028.95	14631.20	21446 37	8083.09	7276.62	8224 28
Balance	−78.14	−644.48	−1156.00	−1791 70	−1227 07	−2774.58	−4431.44	−1798.04	−1829.57	+205.84
Overall Balance	−18.92	−395.00	−936.00	−772.25	−813 36	−2363.86	−2052.62	−1505 73	−2700.27	−1235.42

Source: RBI Bulletin (various issues) and Explanatory Memorandum on the Budget of the Central Government, 1975-76 to 1980-81.

*Net of States' share.

**Based on Interim Budget.

whole, and more than thrice the figures for the Second Plan. The increase on capital account has been still more rapid. Capital receipts have gone up by about 80 times during these years. And in 1980-81 they were more than eight times as much as in the First Plan. Another general feature of the Central Finances is that for most years, there has been a surplus on revenue account, while the capital account has consistently shown a deficit. It must be noted that debt receipts are included in capital account and the excess of total disbursements over total receipts (including loans) is counted as deficit. This deficit is financed by drawing down of cash balances and by borrowings from the Reserve Bank of India through the sale of treasury bills. There has been a persistent overall deficit even in this sense of the term, and as the figures in Table 20.1 show, the deficit has tended to increase with the passage of time. Up to a certain limit deficit financing, which adds to the supply of money in the country, is quite welcome. Some increase in money supply is needed to help the economy in its process of monetizing the existing barter sector. But if money supply increases at a faster rate than can be absorbed through increased monetization of the economy, the result is inflationary pressures. It is argued that the market loans are anti-inflationary since they absorb a part of purchasing power from the market. At the most, it is stated, such loans only shift the purchasing power from the market into the hands of the government and do not make any net addition to the total demand. This is not necessarily true. In India, the general public gives loans to the Government in the form of contributions to Provident Fund, small savings, and the like. Marketable loans are almost wholly, taken up by the institutions like the banks, Life Insurance Corporation, Reserve Bank of India etc. Borrowings from the Reserve Bank of India through these dated loans have the same effect on money supply as the borrowings through the issue of treasury bills.

Secondly, when the purchasing power is shifted from the public to the authorities, an imbalance between demand and supply takes place. The authorities invest a major portion of the newly acquired purchasing power in capital goods sector where it takes time for the production to start while the purchasing power gets redistributed to the public through salaries, purchases and other government expenses. Thus, though the government plays a useful and crucial part in savings and capital accumulation in the country, it also contributes to the inflationary pressures in the process.

We should note the fact that the government has been able to raise the tax and non-tax revenue sufficiently rapidly. Total tax

revenue (after meeting the States' share) went up from Rs 357.0 crores in 1950-51 to Rs 8725.01 crores in 1980-81 (BE). And if we compare the figures of the tax revenue before the States' share we find that they were Rs 12301.61 crores in 1980-81 as against Rs 404.52 crores in 1950-51. Non-tax revenue, in a similar manner went up from Rs 48.86 crores to Rs 3402.30 crores. It is very impressive increase in itself, but we must remember that a major portion of it consists of interest receipts on loans which the Central Government has advanced to State Governments and other parties. Non-tax revenue could be far greater if the investment in public undertakings had been as paying as expected. In terms of non-tax revenue, therefore, the performance of the Government of India cannot be considered very creditable.

EXPENDITURE TRENDS

Revenue Account. This brings us to the consideration of the overall expenditure trends and policy of the Government of India. Tables 20.2 and 20.3 provide information regarding the Central Government expenditure (on revenue account) between different categories including developmental and non-developmental ones. It will be seen that, as noted earlier, the total expenditure on revenue account has increased quite rapidly since 1950-51. And though both the developmental and non-developmental expenditures excluding expenditure on defence have moved up, a much larger percentage is now going into developmental expenditure than before. For example, at the beginning of the Annual Plans (in 1966-67) the developmental expenditure was Rs 517.71 crores and it rose to Rs 5162.29 crores (or roughly ten times) by 1980-81. During the same period, the non-developmental expenditure increased from Rs 956.82 crores to Rs 5369.44 crores (or approximately 5.6 times).

Let us start with comments on non-developmental expenditure in which some categories have shown a relatively limited growth only. For example, the cost of collection of taxes increased from Rs 10.24 crores in 1950-51 to Rs 143.29 crores in 1980-81. Similarly, pensions etc. increased from Rs 6.99 crores in 1950-51 to Rs 55.50 crores in 1980-81. Expenditure on currency, coinage and mint has gone up from Rs 22.79 crores in 1967-68 to Rs 44.23 crores in 1980-81.

But there are other categories which have increased very rapidly such as expenditure on civil administration, which went up by 30 times during the same period. This was partly on account of higher salaries, and partly on account of bigger establishment of police and other

TABLE 20.2

GOVERNMENT OF INDIA EXPENDITURE—REVENUE ACCOUNT

(*Rs in crores*)

	1950-51	*First Plan*	*Second Plan*	*Third Plan*	*Annual Plans*	*Fourth Plan*	*Fifth Plan 1974-78*	*1978-79*	*1979-80 R.E.*	*1980-81 B.E.*
Total Expenditure	346.64	1982.97	3342.87	7691.99	7373.02	19577.15	30784.59	10947.62	12047.53	13568.57
Defence Services (net)	164.13	895.67	1178.21	2874 02	2589.06	6284.23	8904.50	2613.90	3010.44	3036.84
Total Expenditure (excluding defence)	182.51	1087 37	2164.66	4817 97	4783.96	13292.92	21880.09	8333.72	9037.09	10531.73
of which										
1. Cost of Collection of Taxes and Duties	10.24	58.41	93.72	124 93	107.06	247.55	363.32	110.57	122.05	143.29
2. Civil Administration	21.29	138.34	238.88	389.13	332.62	1012.88	1505.47	442.98	463.93	637.70
3. Interest Payments	37.36	199.18	276.34	370.62	1493.08	3498.54	5124.70	1828.97	2206.23	2597.64
4. Pensions etc.	6.99	42 83	47 73	52.24	35.11	79.04	114.02	46.32	51.67	55.50
5. Grants to States, Union Territories and Local Bodies	15.59	131.68	217.90	1231 59	1435.14	4058.35	5998.49	2680.66	2349.62	2307,59

Source: Various Issues of RBI Bulletin and Explanatory Memorandum on the Budget of Central Government, 1975-76 to 1980-81, Annexure I

TABLE 20.3

DEVELOPMENTAL AND NON-DEVELOPMENTAL EXPENDITURE OF THE GOVERNMENT OF INDIA —REVENUE ACCOUNT

(Rs in crores)

	1966-67	1967-68	1968-69	Annual Plans	Fourth Plan	Fifth Plan 1974-78	1978-79	1979-80	1980-81
A. Non-Developmental Expenditure excluding defence Expenditure	956.82	1018.74	1085.83	3061.39	7090.60	11156.75	3821.48	3812.46	5369.44
B. Developmental Expenditure	517.71	600.33	697.30	1815.34	6300.28	10723.35	4512.24	5224.63	5162.29
of which									
I. Social and Community Services	144.94	165.50	185.22	495.66	1048.51	2211.88	725.34	791.89	870.82
II. Economic Services	161.99	169.99	185.56	517.54	2127.61	5077.74	2034.03	2448.43	2515.52
of which									
1. Agriculture and allied Services	21.63	27.03	38.00	87.46	723.41	2261.97	908.22	871.07	896.15
2. Industries and Minerals	30.10	30.52	32.87	93.49	305.50	1014.14	359.91	746.78	752.95
3. Foreign Trade and Export Promotion	42.55	2.68	34.00	99.23	292.89	884.55	419.80	382.49	368.06
4. Water and Power Development	2.04	3.34	2.14	7.52	83.60	309.44	104.10	126.67	147.43
5 Transport and Communications	28.44	32.37	38.02	98.83	274.57	390.70	149.89	215.21	235.44

III Grants-in-aid to State and Union Territories for Developmental Purposes	210 78	264 84	326 52	802 14	2759 09	3430 76	1751 53	1980 47	1769 23
IV General Services						2 97	1 34	3 84	6 72

Source: Explanatory Memorandum on the Budget of the Central Government, 1975-76 to 1980-81, Annexure I, Appendix III

general civil administration. The most rapid increase in non-developmental expenditure is accounted for by interest payments. From a mere Rs 37 36 crores in 1950-51, they rose to Rs 199.18 crores in the First Plan, to Rs 276.44 crores in the Second Plan and to Rs 370.62 crores in the Third. During the Annual Plans, the interest payments amounted to Rs 1493.08 crores and in the Fourth Plan the figures totalled to Rs 3498.54 crores. They further rose to Rs 5124.70 crores for 1974-78 and are now consuming nearly half of the non-developmental expenditure excluding expenditure on defence on revenue account. They were Rs 2597.64 crores out of a total of Rs 5369.44 crores of non-developmental expenditure in 1980-81. Even of total expenditure (excluding defence) on revenue account, interest payments accounted for approximately 25% in 1980-81. The reasons for this heavy drain on revenue are not far to seek. The Government has increased its interest-bearing liabilities year after year through various means. Along with market borrowings, there are small savings, borrowings through the sale of treasury bills, and external loans. Moreover, the rate of interest has shown an upward trend making new loans more expensive. Still another important category is the non-developmental grants (which are in addition to the developmental grants on revenue account) to States and Union Territories. From Rs 195.11 crores in 1966-67, they steadily rose to Rs 882.98 crores in 1978-79. The fall in later years is on account of the recommendations of the Seventh Finance Commission.

Our defence commitments have gone up on account of a number of factors. With rising prices, it is now far more expensive to modernize armaments and equipment. Training of troops and technical personnel now cost more. Our relations with some of our political neighbours also compel us to spend more for defence purposes. We find, therefore, that a sizeable portion of our expenditure on revenue account goes to defence. Starting with Rs 164.13 crores for 1950-51 and Rs 895.67 crores for the whole First Plan, it increased only marginally to Rs 1178.21 crores in the Second Plan. The Chinese aggression of 1962 pointed towards a need for stronger defence and our defence expenditure touched Rs 2874.02 crores during the Third Plan. Since the need for a proper defence for the country has persisted, our defence expenditure (on revenue account) has continued to move steadily up. For the Annual Plans, the Fourth Plan and Fifth Plan (1974-78) it amounted to Rs 2589.06 crores, Rs 6284.23 crores and Rs 8904.50 crores respectively. In 1980-81 (BE) provision for defence stood at Rs 3036.84 crores or around 22.4% of the total revenue disbursements. Thus, of the non-developmental expenditure on revenue

account, the major portion is accounted for by civil administration, defence, interest payments and grants to State and Union Territories Governments.

Table 20.3 provides some details of the developmental expenditure. Here the first category is of Social and Community Services which rose moderately from Rs 144.94 crores in 1966-67 to Rs 870.82 crores in 1980-81. Economic Services have risen far more rapidly during the same period—from Rs 161.99 crores to Rs 2515.52 crores. Economic Services include such items as agricultural and allied services, industries and minerals, foreign trade and export promotion, water and power development, and transport and communications. Within economic services, agriculture and allied services claim the largest share followed by industries and minerals and foreign trade and export promotion. Grants-in-aid to States and Union Territories is another major head for developmental expenditure on revenue account From an amount of Rs 210.78 crores in 1966-67, the figure rose to Rs 1769.23 crores in 1980-81.

Capital Account. On capital account, a major portion of disbursements is in the form of loans and advances to the States, Union Territories and other parties.[1] Thus, in 1950-51, the States got Rs 61.46 crores from the Centre under this head, and for the First Plan, these loans and advances amounted to Rs 715.21 crores. During the Second Plan the figure nearly doubled to Rs 1420 64 crores and during the Third Plan moved to Rs 3054.74 crores For the three years of the Annual Plans also they got Rs 2738.10 crores, while for the Fourth Plan the figure totalled to Rs 6829.81 crores. With the end of the Fourth Plan, these loan figures declined but again resumed the upward trend. In the years 1979-80 RE and 1980-81 BE, these figures stood at Rs 2798.52 crores and Rs 2796.09 crores respectively. These loans and advances have been mainly, though not entirely, for developmental purposes. It is noteworthy that the loans from the Central Government to parties other than States and Union Territories Governments are also increasing rapidly with the passage of time. These parties include cooperative societies, agricultural financial institutions, village and small industries, engineering industries, petroleum, chemicals, fertilizers, mining and metallurgical industries, ports, light houses and shipping, railways, export promotion, and the like. Thus in 1966-67, out of a total of Rs 1407.28 crores, these parties got Rs 476.39 crores; by the end of the Fourth Plan (1973-74), their

[1]Note that repayments of loans by the Central Government are accounted for on the capital receipts side where borrowings net of repayments are shown.

TABLE 20.4

GOVERNMENT OF INDIA EXPENDITURE— CAPITAL ACCOUNT

(*Rs in crores*)

	1966-67	*1967-68*	*1968-69*	*Annual Plans*	*Fourth Plan*	*Fifth Plan 1974-78*	*1978-79*	*1979-80*	*1980-81*
I. Developmental Expenditure *of which*	511.08	465.34	498.88	1475.70	3685.95	6724.29	1887.84	2241.46	2469.76
A. Social and Community Services	1.59	4.55	3.64	9.78	98.46	340.71	104.60	108.06	157.29
B. Economic Services *of which*	509.89	460.79	495.24	1465.92	3587.49	6383.58	1783.24	2090.73	2267.05
(*i*) Agriculture and Allied Services	2.46	6.85	7.07	16.35	44.43	793.82	147.40	350.76	344.68
(*ii*) Industry and Minerals	191.03	170.03	227.44	588.50	1642.24	3370.58	827.88	781.05	861.43
(*iii*) Water and Power Development	17.18	19.52	25.69	62.39	290.52	451.39	192.29	312.84	371.46
(*iv*) Transport and Communications	54.24	44.61	53.11	151.96	[illegible]	485.45	143.05	178.35	214.06
(*v*) Railways	[illegible]	135.93	121.47	418.10	801.97	934.32	361.41	397.40	374.00
(*vi*) Posts and Telegraphs	29.77	26.44	26.72	82.93	162.44	182.07	26.04	17.60	63.30
(*vii*) General Economic Services	...	...	...	...	53.08	166.12	85.17	52.73	48.12
(*viii*) Others	54.51	57.41	33.74	145.66	91.42	...	...	...	...
C. General Services	..	.	..	...	..	*	*	42.67	45.42
II. Defence Expenditure	110.79	106.22	104.14	321.15	874.27	867.25	253.73	262.56	263.16
III. Other Expenditure	322.07	95.04	−175.11	242.0	−60.73	392.78	276.05	4.99	635.18

IV. Loans and Advance	1407.28	1363.77	1497.91	4268.96	10014.25	13453.05	5665.47	4767.61	4856.18
of which									
To States and Union Territories	930.89	891.94	915.91	2738.10	6829.81	5825.17	3324.40	2798.52	2796.09
Others	476.39	471.83	582.00	1530.85	3184.44	7627.88	2341.07	1969.09	2060.09
Total Capital Disbursements	2351.62	2030.37	1925.82	6307.81	14635.20	21446.37	8083.09	7276.62	8224.28

Source: Explanatory Memorandum on the Budget of the Central Government, 1975-76 to 1980-81.
*Included in III.

share went up to Rs 856.32 crores out of Rs 2431.92 crores and in the next year (1974-75), their share exceeded that of the States. In 1980-81, they got Rs 2341.07 crores as against Rs 3324 40 crores going to the States. In 1980-81, direct developmental expenditure on capital account was 4.4 times that in 1966-67. It is seen that of this category, only a small portion has been spent on social and community services, the balance going to economic services which cover agriculture and allied services, industries and minerals, water and power development, transport and communications, railways and posts and telegraphs. Thus social and community services got only Rs 1.59 crores against Rs 509.89 crores going to economic services in 1966-67, Rs 108.06 crores against Rs 2090.73 crores for economic services in 1979-80 and Rs 344.68 crores as against Rs 2267.05 crores for economic services in 1980-81. It must be emphasised that most of the capital disbursements are meant for developmental purposes—whether they are in the form of loans and advances or in the form of direct government expenditure. A part of the capital disbursements has been claimed by 'defence' also, but the share of this category has not been very large; it was only Rs 110.79 crores in 1966-67 and went up to only Rs 263.16 crores in 1980-81. In terms of real purchasing power, this amount was still smaller.

Expenditure Policy

In any useful budgetary policy, public expenditure has an important and essential role to play. In India, public expenditure assumes special importance because of the responsibilities which the Government has assumed. Through various budgetary measures the Government has to ensure an equitable distribution of income and wealth and decentralization of economic power. There is also the need to bring about a self-sustained and rapid economic growth in the country for which the rates of savings and investment have to be stepped up. A balanced and economical use of the productive resources of the economy has to be there to ensure that the country is able to get best out of its developmental efforts. Control of the commanding heights of the economy must be acquired through the creation and control of the basic and key industries. Expenditure policy of the Government, therefore, assumes a special significance in the light to all these objectives. It is no longer to aim only at maintenance of the administration, law and order and protection against foreign aggression.

Broadly speaking, the expenditure policy of the Government may partly be judged by looking at its consumption and other components.

TABLE 20 5

GROSS CAPITAL FORMATION OUT OF THE BUDGETARY RESOURCES OF THE CENTRAL GOVERNMENT

(*Rs in crores*)

	1950-51	*First Plan*	*Second Plan*	*Third Plan*	*Annual Plans*	*Fourth Plan*	*Fifth Plan 1974-78*	*1978-79 B E.*
A. Gross Capital Formation by Central Government	80 1	612 3	1444.5	2445 1	1243 2 (1301.2)[a]	2968.7	4785.0	1629.4
(a) Fixed Assets	79.5	593 9	1362.3	2355 4	1410 6	2857.6	4134.4	1463.6
(b) Works Stores	9.9	9.8	8.3	99.5	12 2	104.1	55.0	59.1
(c) Increase in Stocks of Foodgrains etc.	(—)9.3	8.6	73 9	(—)9.8	—179.6 (—121.6)[a]	7.0	595.6	106.7
B. Gross Financial Assistance for Capital Formation	41 7	992 7	2460 3	4706.6	3884.3 (3694.3)[a]	7942.2	14445.0	5417.5
(a) To State Governments and Union Territories	41.1	815 7	1373 2	2837.4	2127.2	4570.3	6403.3	2829.6
(b) To non-Departmental Commercial Undertakings*	5.2	81.1	932 4	1658.8	1593.5 (1403.5)[b]	2750.8	7335.7	2324.1
(c) Others**	2.4	95.9	154 7	210.4	163.6	621.1	706.0	263.8
C. Total (A+B)***	128.8	1605 0	3904.8	7151.7	5127.5 (4995.5)	10910.9	19230.0	7046.9

D. Consumption Expenditure	234.7	1241.3	1961.5	4256.0	3877.5	9775.4	13741.1	4139.9
E. Total Expenditure	503.7	3751.2	7822.6	15260.8	13481.4	32993.7	50347.6	17516.7

*Public undertakings operated by autonomous Corporations and Companies.

**Includes loans and grants to local authorities for capital formation

***Excludes investment in shares by the Central Government.

[a]Excludes transfer of Foodgrains to the Food Corporation amounting to Rs 58 crores.

[t]Excludes loans to Food Corporation of India for stock piling of foodgrains amounting to Rs 190 crores.

Source: Economic Survey, 1974-75 to 1978-79 and An Economic and Functional Classification of Central Government Budget.

Table 20.5 describes the gross capital formation out of the budgetary resources of the Central Government. It will be seen that the Centre not only engages in capital formation activity itself, it helps the State Governments, non-departmental commercial undertakings and other parties also in this task. The process of capital formation was quite slow at the beginning and for obvious reasons (since the total budgetary resources at the disposal of the Government were not much), but the process gathered momentum in due course of time. Thus in 1950-51, the total gross capital formation amounted to only Rs 128.8 crores, but by the end of First Plan it had reached Rs 483.3 crores, thus giving a total of Rs 1605.0 crores. Similarly, for the Second Plan the gross total was Rs 3904.8 crores which increased to Rs 7151.7 crores in the Third Plan. The figures for the Annual Plans, the Fourth Plan, the Fifth Plan (1974-78) and 1979-80 (BE) were Rs 5127.5 crores, Rs 10,910.9 crores, Rs 19230 crores and Rs 7046.9 crores respectively. These figures do not cover investment in shares by the Government of India. Out of the total capital formation, the portion formed directly by the Central Government is however smaller than the one formed through assistance to the State Governments, non-departmental undertakings and other parties. In earlier years of our planning era, a major portion of this financial assistance went to the State Governments, but over the years the share of non-departmental commercial undertakings (as compared with that of the State Governments) has increased and in the 1979-80 (BE) we find them getting Rs 2324.1 crores as compared with Rs 2829.6 crores going to the State Governments. The help to other parties has increased to a much smaller extent in absolute terms—from Rs 2.4 crores in 1950-51 to Rs 263.8 crores in 1979-80 (BE). However, two important points should be noted in this break-up.

Firstly, gross capital formation is not equivalent to capital formation in the sense of addition to the productive capacity of the economy. For that we should look at formation of fixed assets which are always less than the gross capital formation. The latter includes building up stocks of foodgrains, fertilizers and works stores in the case of Central Government and inventories etc. in the case of State Governments and commercial undertakings and others.

Secondly, the consumption expenditure of the Central Government is quite a significant portion of the total expenditure. It was 46.5% of the total expenditure in 1950-51. With the beginning of the planning, however, this percentage started coming down and for the First Plan as a whole, it amounted to 33.1. During the Annual Plans, the percentage rose to 34.8, but there has been a downward long-term

trend. Rising prices, refugee relief, Indo-Pak Wars, relief against natural calamities, revisions of pay scales and allowances of the Government employees were some of the important forces contributing to rising Government consumption expenditure. The figure for 1979-80 BE was 23.6%.

Irrespective of the percentage changes, the fact remains that consumption expenditure of the Central Government is too high and has risen rapidly, in absolute terms, from 1960-61 onwards. Thus while from 1950-51 to 1960-61, it rose from Rs 234.7 crores to Rs 433.0 crores, in 1970-71 it was Rs 1669.4 crores and in 1974-75, Rs 2866.8 crores. The figure rose to Rs 3819 2 in 1977-78 (RE) and Rs 4139.9 crores, in 1978-79 (BE). Further, we find that our defence requirements have compelled us to divert a sizeable proportion of our resources from other developmental uses. This is an item for which we have no choice since defence and independence of the country are the first responsibility of every government. The government, in recognition of the need to ensure efficient and economical use of funds has decided to appoint a Commission with suitable terms of reference to conduct a comprehensive inquiry into government expenditure. It will, among other things, examine the impact of public expenditure on the promotion of poverty and recommend ways and means of making public expenditure more effective.

Over the last decade or so, subsidies have come to occupy an increasingly important position in our public expenditure. Subsidies amount to negative taxation. They can be used to help specific economic activities and welfare programmes. In India, we have adopted a set of objectives towards which our fiscal policy is directed These objectives include adoption of a public distribution system of essential commodities, removal of regional disparities, reducing unemployment, helping village and small industries, developing agriculture, and helping weaker sections of the society. To this end, subsidies come as a handy tool in the hands of the authorities. The fact that they cause a heavy drain from budgetary resources has not deterred the authorities from their extensive use. They have been extended to various imports, food and fertilizers, village and small industries and so on. For example, in 1970-71, the Central subsidies were only Rs 94 crores but increased to Rs 1504 crores in 1978-79 and stood at Rs 1489 crores in 1979-80 For both the Central and State Governments put together, the subsidies stood at Rs 337 crores in 1970-71 (equivalent to 5.9% of total public expenditure) but by 1978-79 they had shot up to Rs 2107 crores (13.5% of total public expenditure).

Control of Public Expenditure in India

It is imperative to have built-in controls and checks to ensure that public funds are not wasted and are used most judiciously and carefully for the benefit of the society. Over time, various such measures of control have been devised. It is not possible to proceed on the assumption that each government official would be both honest and efficient, and therefore if government official were asked to spend solely on the basis of their individual discretion and without any set rules and regulations, there would be a lot of wastage of public funds. Cases of misappropriation are also likely to be frequent. Even if we assume that the officials are both honest and efficient, it has to be ensured that public expenditure follows a set policy laid down for this purpose by the authorities.

We shall illustrate the nature of control over public expenditure in India by referring to the practice at the Central Government level. Corresponding comments apply to other levels of governmental authority. *The first stage* of control over public expenditure is the preparation of *annual budget* itself. Budget preparation is an elaborate exercise and is intended (*i*) to systematize the plans to spend and raise revenues along with necessary rates, rules and regulations, (*ii*) to reflect the economic, social and other policies of the Government, (*iii*) to provide the legislature with all the relevant information regarding the policy contents and the amounts involved, (*iv*) to get express sanction and authority from the legislature to raise the said revenues and spend them, (*v*) to provide a basis for ensuring that the executive remains bound to the budget and does not deviate from it, and (*vi*) to provide a subsequent means for auditing and scrutiny of the actual implementation of the financial plans.

Without going into procedural details, let us note that the budget is a plan for the financial operations covering the coming year. In such a budget, the estimates of revenues and disbursements for the year just ending are presented both as they were made originally and as they appear to be materialising on revised basis. The discrepancy between the two, if any, is also explained. Along with, full estimates of revenues and disbursements for the coming year are also presented. Before the presentation of the actual budget, Parliament is presented with an *Economic Survey* outlining the economic conditions in the country and the prospects for the coming year as also the important issues which need tackling. This sets the scene for the type of policy implications which the budget proposals should have. The budget itself is an elaborate thing. Our Constitution makes it obligatory for the Government to divide the budget into revenue and capital

accounts portions. In the capital account those receipts and disbursements are included which are in the nature of acquisitions and disposal of capital assets. The income from and expenditure on the maintenance of capital assets go to the revenue account. Thus while loans (both receipts and repayments) are in the capital account, interest receipts and payments are in the revenue account. Additionally, we have the break-up of both receipts and disbursements in terms of various major heads, minor heads and sub-heads. Furthermore, break-up in terms of departments, ministries etc., is made available. Currently, we have also the break-up in terms of economic and functional classification together with many estimates of economic and social significance. Along with these details, important relevant details of individual estimates are provided. Additionally, we have also the Plan budget. This includes the details of important schemes which are to be financed through budgetary operations and are in the plan for the year.

Now comes the stage of presenting the budget to Parliament and getting its approval. Our Constitution enables the authorities to present the budget before Parliament in more than one parts. Accordingly, the budget is presented in two parts. The first part consists of the Railway Budget In the second part, the rest of the budget is presented incorporating the receipts from and expenses on railways. The presentation of the main budget is preceded by a speech by the Finance Minister. The first part of the speech highlights the type of issues facing the economy and second part puts forth the main budgetary proposals including tax proposals and concessions. This is followed by moving the Finance Bill in Parliament to provide legal validity to the budgetary proposals. Furthermore, Demand for Grants are presented for each Ministry and Department with necessary details and division into heads, minor heads and sub-heads.

It may be stated that in spite of sufficient information about the performance in the outgoing year and estimates about the coming year, Parliament comes into contact with *only policy aspects* of the budget. It is mainly these aspects which are highlighted. Parliament has no means of judging the accounting accuracy of these estimates.

The next stage of control over public expenditure lies in the executive set of the government itself. Here the general instructions are that public funds should be spent with utmost care, prudence and propriety to avoid wastage etc. Here the financial control is based upon two components. The first is that of fixing the standards of financial propriety which may involve the calling of tenders etc. The second is that of fixing the levels of responsibility. The Ministry of

Finance has been given an overall responsibility to process and coordinate all proposals having financial implications, though matters of routine financial nature are handled by respective departmental heads and so on. A whole system of rules and regulations has been devised to ensure that no official is able to misuse or misappropriate the funds. No amount can be spent (even when it has been provided for) unless a specific sanction is obtained from the appropriate authority. Also, in each department, there are accounts sections whose job is to effect the spending, while actual order to spend is issued by a different authority. Through all these intricate rules and regulations, it is sought to ensure that only that amount of money is spent which is legally available and which has been specifically authorized to be spent. It is also not permitted to divert the money from one authorized purpose to some other and it is expected to be spent with utmost propriety and care.

The next stage of control over public expenditure comes with the auditing. The Auditor General of India audits the Government accounts, as also the accounts of the public corporations etc and prepares the audit reports. The accounts are audited with respect to their proper maintenance, observance of all the rules and regulations while spending the funds, and whether or not propriety and care were observed. However, the inherent weakness of the system of auditing is that the government machinery gets geared to only audit objections. It gets less concerned with efficient ways of spending and more concerned with technical faults (whether in good faith or not). Efficient performance is not given any credit by audit reports but technical faults are pointed out and objected to. Thus the whole public spending has tended to be audit-oriented with the result that delays and unnecessary paper-work mount up at the executive level. Each official tries to avoid that decision which could possibly attract audit objection.

This defect is being indirectly removed to some extent through the introduction of economic and functional classification, and performance and programme budgeting. Audit control cannot look into the type of inefficiency and wastage that takes place on account of wrong policies (such as spending too much for consumption purposes and too little for capital accumulation, or uplift of the weaker sections of the society). Economic and functional classification tackles this problem to some extent by providing an insight into economic and other implications of the budgetary operations. Similarly, performance and programme budgeting contributes to our understanding of the nature and extent of inefficiency and wastage. We have

discussed this type of budgeting in another part of this book.

The last stage of control over public expenditure is again with Parliament which has always the right to inquire into any particular item of expenditure or a deal etc. which the government entered into. Parliament, has constituted two specific committees to regularity look into certain aspects of public expenditure. The first is the *Public Accounts Committee.* It examines the Appropriation Accounts and Report of Comptroller and Auditor General to note the lapses on the part of the Executive and follows them with further investigations and enquiries if need be. It also examines the income and expenditure accounts and profit and loss accounts of autonomous bodies. public corporations, trading and manufacturing schemes etc. with the same objectives of legality, authorization, propriety etc. It may however be noted that the task of the Accounts Committee, though very helpful. is in the nature of a post mortem. It cannot anticipate areas of mismanagement to suggest preventive measures.

The second committee of Parliament is the *Estimates Committee.* Its task is to maintain an overall supervision of the financial affairs of the executive so as to indicate possible economies in expenditure without loss of efficiency. Consistent with policy underlying the estimates, it recommends possible reforms and improvements in efficiency It also suggests alternative policies for enhancing efficiency and the forms in which estimates should be presented to Parliament.

TRENDS IN RECEIPTS

Revenue Account. Having discussed the trends in Government of India expenditure, let us look at the revenue trends. Receipts of the Central Government are also divided into revenue and capital accounts. During the period 1950-51 to 1980-81, total revenue receipts of the Central Government multiplied by about 30 times from a mere Rs 405.86 crores to Rs 12127.3 crores. Of these the major portion has always been contributed by tax revenue which was Rs 357.0 crores in 1950-51 and Rs 8725.0 crores in 1980-81.

Starting with non-tax revenue we note the following main features: *Firstly*, administrative receipts have always remained quite small as compared with the total non-tax revenue receipts.

Secondly, though net contribution by public undertakings apparently show an impressive increase, actually the performance of this category is not satisfactory. If we ignore the profits of the Reserve Bank of India, we find that the performance of public undertakings which include railways and posts and telegraphs also, has been not

TABLE 20.6

REVENUE RECEIPTS OF GOVERNMENT OF INDIA

(*Rs in crores*)

	1950-51	*First Plan*	*Second Plan*	*Third Plan*	*Annual Plans*	*Fourth Plan*	*Fifth Plan 1974 78*	*1978-79*	*1979-80*	*1980-81†*
I. Taxes on income and Expenditure	125.7	587.0	810.6	1866.2	1445.7	3031.4	5743.9	2453.39	2701.00	2930.50
Income Tax	132.7	664.1	803.6	1148.3	1012.8	2833.5	4285.2	1177.39	1320.00	1426.00
Less States' Share	47.5	278.2	374.7	555.5	506.1	2133.5	2574.0	706.62	864.88	932.20
Net Amount	85.2	385.9	429.0	592.8	506.7	694.8	1711.2	470.77	455.12	493.80
Corporation Tax	40.5	201.1	379.3	1271.4	939.0	2336 6	3776.2	1251.47	1380.00	1504.00
Other Taxes on Income and Expenditure	...	...	2.3	2 0	0 1	...	256.5	24.53	1.00	0.50
II. Taxes on Property and Capital Transactions	3.8	13.7	58.4	83.7	59.9	194.7	306.5	95.14	78.00	80 08
Estate Duty	...	2.6	13.1	24.9	19.4	44.3	47.8	13.07	13.00	13.00
Less States' Share	...	2.4	12.9	24 6	16.7	39.7	37.3	10.70	10.94	10.90
Taxes on wealth	...	...	37.0	50.6	32 4	127 8	201.8	55.41	63.00	65.00
Gift Tax	...	...	2.7	7.6	4.6	16.8	21.5	5.85	6.25	6.25
Stamps and Registration	1.8	8.1	15.9	24.3	19.7	44.2	71.3	31.20	6.42	6.46
Land Revenue	2.0	5.4	2.6	1.9	0.6	1.3	1.4	0.31	0.27	0.27
III. Taxes on Commodities and Services	227.5	1372.9	2125.7	4708.2	4383.9	11689.1	18622.2	6726.37	6304.59	6646.63
Customs (Net)	157.2	915 7	817.7	1729.4	1545.2	3496.1	6053.5	2423.51	2814.00	3004.00
Union Excise Duties	67.5	517.3	1554.0	3517.2	3503 0	1027.4	15744.3	5367.17	5825.00	6067.90
Less States' Share	..	64.1	281.2	614.8	756.5	2383.6	3700.5	1239.50	2530.20	2633.50
Net Amount	67 5	453.2	1272 8	2892.3	2746 5	7886.8	12043 7	4127.67	3294.80	3434.40

Other Taxes and Duties (net)	2.8	4.0	35.3	76.4	92.2	305.9	525.0	175.19	195.79	208.23
IV. Total Tax Revenue (net)	357.0	1973.6	2994.7	6658.1	5889.5	1495.2	24672.6	8568.28	8218.71	8725.01
V. Total Non-Tax Revenue (net)	48.9	258.9	568.1	2053.1	1897.2	5020.9	8415.5	2671.65	2958.12	3402.30
of which										
Interest Receipts	2.1	14.3	42.9	973.9	1317.4	2899.2	4235.2	1426.85	1484.67	1812.87
Others*	46.8	244.6	525.2	1079.2	579.3	2121.7	4180.3	1244.80	1473.45	1589.43
VI. Total Revenue (IV+V)	405.9	2232.5	3562.9	8711.4	7786.7	19936.1	33088.1	11239.93	11176.83	12127.31

*Include fiscal services, dividends, grants-in-aid and contributions, administrative receipts, etc.

†Based upon Interim Budget

Source: Various issues of RBI Bulletin and Explanatory Memorandum on the Budget of the Central Government for 1975-76 to 1980-81.

at all impressive. The contribution of public undertakings other than railways and posts and telegraphs, was quite small throughout. Even the budget for 1980-81 puts their dividends and profits at only Rs 289.20 crores. This is all the more striking in the light of the fact that the total investment of the Government of India in these undertakings by way of investments, loans and advances has increased year after year. Some detailed account of these matters will be found in the chapter on public undertakings in India. We may conclude that an important reason for the relatively slower increase in non-tax revenue is the failure of public undertakings to contribute their due share.

The Third salient feature of non-tax revenue of the Government of India is the steadily increasing interest receipts. The Government of India advances sizeable loans to State Governments, public undertakings and other parties every year and as a result the interest receipts are steadily going up.

The tax revenue of the Central Government may be divided into (*i*) taxes on income and expenditure, (*ii*) taxes on property and capital transactions, and (*iii*) taxes on commodities and services. Taxes on commodities and services provide the maximum revenue followed by taxes on income and expenditure while the contribution of taxes on property and capital transactions is only nominal.

Taxes on income and expenditure consist of income tax and corporation tax. An expenditure tax on personal consumption was first imposed in 1958 in the wake of the recommendations made by Kaldor who had emphasised this tax as part of an integrated system of direct taxes. The idea was to plug the possibility of tax evasion and discourage unnecessary consumption. However, the tax yield was quite small and its administration very difficult. It was abolished in 1962 and was reintroduced in 1964 but was finally abandoned in 1966. In the Supplementary Budget of July 1974 a new tax on interest earnings of State Bank of India, and its subsidiaries, the nationalised banks and the other scheduled banks was imposed under the Interest Tax Act, 1974 but was abolished in 1978-79.

As between income and corporation taxes the latter, though quite small in yield in the beginning, has caught up with yield from income tax. Compared with Rs 40.42 crores in 1950-51, it has raced to Rs 1504.3 crores by 1980-81 while income tax yield increased during the same period from Rs 132.73 crores to Rs 1426.0 crores. The net share of the Centre from income tax, however, has not increased as rapidly since successive Finance Commissions recommended a larger

percentage share for the States.[2] For example, in 1950-51, the State Governments got Rs 47.52 crores out of income tax receipts of Rs 132.73 crores; while in 1980-81 they got Rs 932.20 crores out of Rs 1426.0 crores. It may be noted that apparently the proportion of income tax proceeds going to the States is less than the specified percentage to which the States are entitled. For example, if we take the year 1980-81, the States were entitled to 85% of the net proceeds of income tax, but the figure of Rs 932.20 crores is less than 85% of Rs 1426.0 crores. The explanation lies in the fact that before calculating the States' share certain deductions are made. Thus in 1980-81 the following deductions (totalling Rs 329.29 crores) were made. The figure Rs 1426.0 crores includes Union Surcharge (Rs 215.0 crores), taxes payable in respect of Union emoluments (Rs 21.0 crores) and miscellaneous receipts Rs 15.0 crores. Out of the balance Rs 1175.0 crores the cost of collection (Rs 53.73 crores), and the portion attributable to Union Territories (Rs 24.56 crores) are deducted. The remaining balance (Rs 1096.71 crores) is divided between the States and the Centre in the ratio of 85:15 which gives the States a share of Rs 932.20 crores.

The corporation tax, however, is not shared with the States and as such the whole amount goes to the Centre. Corporation tax is defined by Article 366 of our Constitution. A part of income tax paid by the companies did not satisfy clause (c) of this Article, and was shared with the States. In 1959-60, the law of income tax was changed in such a manner that the whole of income tax paid by companies came to satisfy this clause and got defined as corporation tax. This has prevented the share of the States from rising as fast as it otherwise would have.

Taxes on property and capital transactions contribute only a small amount of revenue to the Government. In 1950-51, the yield from this category was barely Rs 3.81 crores and even in 1980-81 it was only Rs 101.88 crores. From the point of view of revenue, the most important tax here is that on wealth which was introduced in 1957 and which in 1980-81 was expected to bring in Rs 65 crores. According to the Wealth Tax Act, 1957, it is an annual tax imposed on the net wealth of individuals and Hindu undivided families. But under the Finance Act, 1976 net wealth below Rs 1 lakh in the case of an individual or a Hindu undivided family is not taxed. The wealth tax pay-

[2]The yield from income tax is compulsorily shared with the States, though the percentage shares of the States and the Centre and other matters are decided only upon the recommendations of the Finance Commission.

able should also not exceed 5% of the amount by which the net wealth exceeds this exemption limit. Additional wealth tax is leviable on the value of land buildings (other than business premises) and rights therein, situated in an 'urban area,' which is included in the net wealth of an individual or a Hindu undivided family. Under the Finance Act, 1969 the value of agricultural property held by individuals and Hindu undivided families was also brought within the purview of the Wealth Tax Act subject to certain limits. The net collections of wealth tax attributable to agricultural property are payable to the State Governments as grants-in-aid.

The second position in terms of tax yield in this category is occupied by Stamps and Registration followed by Estate Duty (whose entire proceeds are assigned to the States) and gift tax. The gift tax was introduced in 1958 as a part of the integrated system of direct taxes as recommended by Kaldor. A tax on gifts was meant to prevent evasion of expenditure tax, wealth tax and estate duty. Gift tax is not imposed upon gifts of small values and the rate of tax is determined on a slab system. However, it may be noted that Kaldor had recommended progressive rates of gift tax not with reference to the value of the gift but with reference to the net worth of the recipient. From the revenue point also, this tax is not of much importance. The estate duty was levied in 1953. The net proceeds of estate duty on agricultural lands are assigned to the States in which these are collected. The net proceeds of estate duty on property other than agricultural lands are divided between the States on a different basis as described in an earlier chapter.

Taxes on commodities and services have always provided the maximum revenue to the Government. In 1950-51, their yield (net of states' share) was about 77% of the total tax revenue while in 1980-81 about 76.1% came from this source. In absolute terms, these taxes have been the backbone of the Government of India revenue, providing Rs 227.49 crores out of Rs 357.0 crores in 1950-51 and Rs 6646.63 crores out of Rs 8725.01 crores in 1980-81. One reason for this rapid growth is the need to raise additional tax revenue and the inability of the authorities to raise direct tax revenue. Though the administration of both direct and indirect taxes has been weak and has allowed a good deal of tax evasion and avoidance, the possibility of extending the tax coverage and raising the rates has been more in the case of indirect taxes. The Central Government imposes a number of excise duties and the yield from them has been increasing at the most rapid rate. Thus, while in 1950-51, Union excise duties yielded Rs 67.54 crores, by 1980-81 the figure stood at Rs

6067.90 crores. A look at the successive Union excise revenue figures shows that the revenue under this head more than doubled from the First Plan to the Second and from the Second to the Third. During the three Annual Plans the yield was about as much as for the five years of the Third Plan while the figure for the Fourth Plan crossed Rs 10,270 crores (that is 2.9 times than what it was in the Annual Plans). The same striking fact is also revealed by year to year variations in the yield under this head especially during the Fourth Plan and after. Union excise duties are levied on a large number of items. In the budget for 1980-81, in addition to coal and electricity generation, basic duties of excise were payable by 131 items. Special duties of excise at the rate of five per cent of the basic duties were also imposed on these 131 items. Fifteen items were subject to cesses and three were subject to additional duties in lieu of sales tax. All other items not specified elsewhere were subject to an *ad valorem* duty of eight per cent. The bulk of the excise revenue, however, comes from a small number of items in basic excise duties. For example, according to the 1980-81 budget only 27 items including electricity generation yielded more than Rs 40 crores as basic excise duties and collectively accounted for 80% of a total of Rs 5553 crores of basic duties. Excise revenue has partly gone up due to wider coverage and enhanced rates. But on several commodities it is on *ad valorem* basis and a rise in prices has also pushed up the yield.

The 1975-76 budget introduced a new concept, first mooted in Bhoothalingam Report. Till then the Central excise duties were being levied on only certain specified goods. But now the budget aimed at achieving two objectives, namely (*i*) to widen the coverage of taxable, goods, and (*ii*) to provide more reliable data for future revenue raising exercises.

Accordingly, the budget proposed to cover, with a few exceptions, all goods produced for sale or other commercial purposes under the Central excise. All items which were not already subject to excise duties were to be charged a duty at the nominal rate of one per cent *ad valorem*. Though the aim was to cover all factories as defined in the Factories Act, 1948, for administrative convenience and other reasons quite a few exemptions had to be granted. This levy was expected to yield a revenue of Rs 24 crores. The rate of this duty was raised to two per cent in 1977-78 and to five per cent in 1978-79, and 8% in 1979-80 with the expected yield of Rs 280 crores. Critics of the new system of levy have vigorously emphasised the administrative difficulties, relatively low yield and a high cost of collection of this set of duties. But experience shows that there is a case for the

retention and extension of this set of duties. Actually, the question of devising a proper rationale and structure of indirect taxation has been debated for quite some time. There have been suggestions that the entire indirect taxation should be replaced by a kind of value-added system (see the Section on Jha Committee Report). Similarly, direct taxation of companies, it has been pleaded, should be based upon expenditure instead of income.

The increase in customs revenue was slower in earlier years, but picked up during the Fourth Plan. The budget estimates for 1980-81 put the figure at Rs 3004.00 crores. This behaviour of customs revenue corresponds with that of the volume of foreign trade. However, it should be noted that a major portion of this revenue comes from import duties, since the authorities do not think it desirable to hamper the growth of exports by imposing heavy export duties. Thus, for example, export duties (gross) amounted to only Rs 47.36 crores in 1950-51 as against Rs 107.70 crores by way of import duties in the same period. By 1974-75, while import duties had increased to Rs 1235.4 crores, export duties were only Rs 94.2 crores. In 1979-80, the import duties recorded Rs 2660.81 crores and export duties, Rs 126.19 crores. The figures for 1980-81 BE are Rs 2817.26 crores and Rs 155.24 crores respectively.

Other taxes and duties in the category of 'taxes on commodities and services' include such taxes which are generally levied by the State Governments and which in this case are coming from the Union Territories such as State excise duties, taxes on vehicles, sales tax, tax on passengers and goods, taxes and duties on electricity etc.

Capital Account. *Capital receipts* mostly consist of borrowings of different kinds and repayments of loans and advances by other debtors to the Government of India. In Table 20.7, capital receipts by way of loans are shown not on gross but on net basis (that is gross borrowings minus the repayment of loans). It is seen that net internal loans (consisting mainly of market borrowings) have increased only slowly, so that even in 1980-81 BE the figure was only Rs 2499.66 crores. This is partly explained by the fact that the general public does not invest in dated loans of the Central Government. Subscriptions to market loans come from institutional investors like the Reserve Bank of India, Life Insurance Corporation etc. The overall economic policies of the Government do not enable even these institutional investors to invest much in Government loans. The interest rate structure of government loans does not make them attractive enough to the investors. Actually most of these market borrowings have been subscribed to because the market is a captive

TABLE 20.7

CAPITAL RECEIPTS OF GOVERNMENT OF INDIA

	1966-67	1967-68	1968-69	Annual Plans	Fourth Plan	Fifth Plan 1974-78	1978-79	1979-80	1980-81
A. Public Debt									
1. Internal Debt									
(i) Market Loans									
Gross Borrowings*	275.30	350.48	320.67	946.45	3399.56	3888.46	1836.78	2258.80	2765.00
Repayments	182.79	256.70	241.54	681.03	1853.53	822.55	183.31	297.51	265.34
Net	92.51	93.78	79.13	265.42	1544.03	3066.91	1653.47	1961.29	2499.66
(ii) Other Debt (Net)	351.51		—6.63	344.88	91.93	39.46	..	...	...
Total	444.02	93.78	72.50	610.30	1635.96	3106.37	1653.47	1961.29	2499.66
2. External Debt									
Gross Borrowings	864.26	788.93	653.83	2307.02	2892.17	4453.20	853.76	939.38	1119.11
Repayments	159.42	187.78	176.39	523.59	2766.35	1450.06	469.90	408.78	410.40
Net	704.84	601.15	477.44	1783.43	125.82	3003.14	383.86	530.60	708.71
B Repayment of Loans and Advances	418.55	494.44	712.38	1655.37	5750.40	6252.51	2081.87	1584.00	2733.00
C. Other Items (Net)									
Small Savings	118.36	123.41	113.71	355.48	1384.53	1628.23	847.21	925.00	1000.00
Provident Funds	47.92	75.62	42.43	165.97	477.66	813.37	286.49	299.99	300.00
Other Heads (Net)**	94.83	331.40	134.02	560.25	2485.35	2211.31	1032.15	146.17	1188.73
Total Capital Receipts	1828.52	1719.80	1582.4[illegible]	5130.80	11856.62	17014.93	6285.05	5417.05	8130.12

*Excludes conversions of ad hoc treasury bills into dated loans

**Excludes notional transfer of PL 480 loans to the Special Development Fund

Source. Explanatory Memorandum on the Budget of the Central Government for 1975-76 to 1980-81, Annexure 1.

one. The loans from the general public are obtained in the form of small savings, provident fund, etc.

External loans (net) have increased quite rapidly over the period under consideration. From a bare net figure of Rs 7.75 crores in 1950-51 they have crossed Rs 1119.11 crores in 1980-81. With the progress of planning and industrialisation, our import requirements of various kinds far outstripped our exports, necessitating large scale external loans and grants. With the progress of the economy, our external loans also went up.

A significant source of capital receipts is the repayment of loans and advances by the debtors to the Government of India. In 1979-80 budget, these repayments are shown at 2733.00 crores. Figure for 1979-80 is lower on account of debt relief recommended by the Seventh Finance Commission. Over the years, the Centre has been giving loans and advances to State Governments, public undertakings and other parties—with their payments falling due in ever increasing amounts.

Other sources of capital receipts include small savings, compulsory deposits, reserve funds, etc. The combined receipts under this head have increased very appreciably (including the collections of small savings). In 1980-81, these capital receipts were Rs 2488.75 crores against Rs 58.28 crores in 1950-51. The small savings included in these figures are Rs 1000.00 crores and Rs 33.52 crores respectively. This figure indicates the growing importance of miscellaneous items like reserve funds, deposits, etc. in the capital receipts of the Central Government.

Deficit Financing

In an underdeveloped country like India, deficit financing has a constructive role to play, though an excessive dose of deficit financing is obviously harmful. Economic growth brings in its wake increasing monetization of the economy. That is to say, economic activities financed through money and other financial assets increase. In order to provide adequate facilities for this transition, it is essential that money supply in the country should grow at an appropriate rate and deficit financing is an important means of increasing money supply. Furthermore, economic growth can be sustained only if there is a sound financial system in the economy which implies the presence of a variety of financial assets in adequate amounts. And as the private credit structure is based, in the final analysis, upon government credit, public debt comes to play an indispensable part in the growth and economic health of the country.

Apart from this indirect necessity of deficit financing, the Government has to take an active part in accelerating capital accumulation. One way of doing this is to undertake the responsibility of shifting the productive resources of the economy into capital goods sector and social overheads, develop basic and key industries and provide the necessary infrastructure in the form of training, education and so on. All this means large scale expenditure on the part of the government for which it may not be able to raise equivalent tax resources. In India we have faced the same problem. The revenue requirements of the government have always been outstripping its availability and investments in public undertakings have not yielded enough of commercial surplus. The gap, therefore, had to be filled through borrowings and deficit financing. It must be remembered that in India, deficit financing is the excess of expenditure over revenue inclusive of receipts from certain borrowings. More precisely, deficit financing is that part of the expenditure which is met by (*i*) ways and means advances, (*ii*) drawings down of cash balances, and (*iii*) borrowings through the issue of treasury bills.

The facility of ways and means advances has not been utilized since 1943 and drawing down of cash balances can take place repeatedly year after year in a cumulative fashion only up to a limit. Issuing of treasury bills, therefore, becomes the main method of financing the deficit.

It must be remembered that deficit financing implies creation of extra purchasing power in the hands of the Government which is then utilized for purchasing away resources from the market. Therefore, the first important impact of deficit financing is a net addition to the demand without a corresponding addition to supply. Moreover, these resources, even if they are used for capital formation, have usually a long gestation period. The production from these investments starts coming to the market only after the lapse of some time. The process of investment expenditure, on the other hand, brings purchasing power into the hands of the public and adds to demand immediately. All told, therefore, unless deficit financing is within the limits set by the expansion of monetization and expansion of output, inflationary pressures develop.

Actual deficit financing, it appears, could be within tolerable limits only during the First Plan. During that period the deficit financing amounted to about Rs 420 crores. The Second Plan saw a greater resource gap and in spite of increased borrowings (both internal and external) deficit financing touched Rs 948 crores. During the First Plan we were able to draw upon our sterling balances which provided

a cushion against any excess of demand over supply. In the Second Plan, however, there was no such cushion available. Among other reasons, therefore, deficit financing contributed its mite to the inflationary pressures and prices went up by about 32% during the Second Plan. In spite of this drawback of deficit financing, the authorities have not been able to keep it within safe limits for years together. During the Third Plan, for example, a deficit financing of Rs 550 crores was stipulated, but actually it turned out to be Rs 1133 crores, resulting in 30% increase in prices. In the later years also, the very process of price rise together with various additional unforeseen commitments in terms of providing dearness allowance, pay revisions, relief against natural calamities and defence measures have led the government to cross the safe limits of deficit financing. For example, events preceding Indo-Pak War of 1971 and the War itself contributed to this deficit. The need to aid States in providing relief against natural calamities and schemes adopted to provide employment relief on a crash programme basis added to the pressures making for increased deficit financing. There have been strikes, revision of pay scales and allowances (in pursuance of the recommendations of the Third Pay Commission) and general increase in Government expenses due to higher prices which have made it impossible for the Government to contain deficit financing. These forces have far outstripped the measures like compulsory deposit scheme and additional taxation. Actually, additional taxation, on account of its taxing of inputs and intermediate goods has itself been inflationary in nature, thereby necessitating still greater deficit financing. The reluctance of the States in resource mobilisation, their general financial indiscipline and overdrafts from the Reserve Bank have also forced the Centre towards greater deficits. The successive figures of deficit from 1970-71 to 1979-80 (BE) are: Rs 326 crores, Rs 460 crores; Rs 831 crores; Rs 650 crores; Rs 721 crores; Rs 368 crores; Rs 135 crores; Rs 975 crores Rs 1505 crores, Rs 2700 crores and Rs 1235 crores.

We must remember that even in the accounting sense deficit financing would have been larger if the Government had not 'funded' ad hoc treasury bills, that is to say if periodically some treasury bills had not have been replaced by long-term dated government securities. (As we have noted earlier, borrowing through long-term securities is not counted as part of deficit financing even though its impact on demand, prices and money supply might turn out to be the same as when the Government borrows through treasury bills.)

Since 1958, the Government has funded treasury bills on a regular

basis. The total amount of treasury bills funded between 1958-59 and 1978-79 was Rs 1925 crores. And if note is taken of these fundings, the figures of deficit financing would appear much bigger. Also in addition to the Central Government's borrowings from the Reserve Bank of India, the State Governments have been resorting to overdrafts from the Reserve Bank of India which also adds to the demand and inflationary forces in the country.

It goes without saying that vigorous steps are needed to eradicate or at least contain the evil of inflation. If inflationary rise in prices is allowed to persist, all planning and developmental efforts are thrown out of gear. The Government itself finds its expenditure increasing which forces it to increase money supply, resort to deficit financing and borrow. These actions of the government further feed the fires of inflation. A seller's market develops which breeds inefficiency and artificial scarcity. Due to reduced availability of supplies, the exports suffer, causing balance of payments deficit. Incomes get redistributed in favour of richer sections of the society. While the organized labour may be able to secure some neutralizing increase in their money wages, the unorganized labour suffers more. Inflation is also a great disincentive for savings since the real purchasing power of savings keeps on falling. Long-term projects become more expensive. Inflation breeds a lot of economic and social discontent. Furthermore, inflation tends to distort the asset preferences of the people. They try to go in for real assets. Artificial scarcities, hoarding of goods in anticipation of greater profits and various other socially and economically undesirable practices come up. And worst of all, inflation starts feeding upon itself. Speculative purchases and hoarding practices add to the difficulties. Inflation also brings in a *hidden taxation* since the *tax liability* increases with rising nominal incomes and prices while the real purchasing power of money incomes does not. Inflation also generates and feeds inequalities of income and wealth. Therefore, those whose incomes do not increase rapidly enough, lose by way of additional taxation as also by way of reduced purchasing power of their money incomes. There can be no two opinions about the desirability of containing inflation. But a policy directed to this end must not be confined to only fiscal measures. Avoiding deficit financing is only one of the many steps which the authorities have to take for curbing inflation. Steps to increase output, checking tax evasion, flushing out black money, curbing of hoarding, prevention of smuggling and other unlawful activities and similar other steps must accompany the avoidance of deficit financing. Monetary measures must be taken to check money supply and credit

expansion. For this, selective credit controls and the like are needed. It may be emphasised that it is through a variety of these steps that the Government was able to contain inflation for some period since September 1974. Every sign of laxity in anti-inflationary measures has threatened to push up prices. The need for a continued vigil for containing inflation cannot be overemphasised.

21 THE INDIAN TAX SYSTEM; CERTAIN ISSUES

OBJECTIVES OF TAXATION

Objectives of a tax system in an economy cannot be considered in isolation from other relevant factors. They are intimately connected with the overall economic and non-economic policies of the government, the non-tax components of its fiscal policy and institutional and other circumstances faced by the economy. As a result, objectives of a tax system in a developed country tend to differ significantly from those in an underdeveloped country like India. It must also be remembered that a number of these objectives can be contradictory and the tax system would have to include diverse taxes with their coverage and rate differentials so as to achieve the best possible results. Also a tax system, by itself, cannot be expected to achieve the set goals fully. It has to fit in the overall set of policies and measures of the government.

The search for an ideal tax system has given rise to an opinion that the indirect taxation should consist of the *value added tax* only and the direct taxes should be consolidated into one. Even in India, while the Indirect Taxation Enquiry Committee (Jha Committee) was requested to study the feasibility of introducing VAT, the Direct Taxes Reforms Committee (Choksi Committee) was asked to consider and recommend on "the advisability of consolidating the laws relating to income tax, sur tax, wealth tax and gift tax into one Act or in any event providing a consolidated return for these taxes." Though VAT has been adopted in some European countries, they have not dispensed with other forms of commodity taxation such as excise duties or consumption taxes. Similarly, the VAT system in developing countries is not as comprehensive as in the European countries. The developing countries have incorporated many exemptions, multiple rates and so on for policy and administrative reasons. This indicates that in spite of many advantages which VAT has over other forms of commodity taxation, most countries (and especially the underdeveloped ones) find that revenue raising with neutral taxes is not the only objective which the government should pursue. For an effective guidance of the economy indirect taxes should have selective

coverage and rate differentials. Similarly, it can be easily argued that different direct taxes should be coordinated and made to supplement each other. Each direct tax has its own set of purposes. They should not be merged into a single tax. Instead they may be assessed through the mean of a single comprehensive return with coordinated information, compatible rates, and so on.

Objectives of Taxation in a Developed Country. The problems of a developed country are materially different from those of an underdeveloped country. A developed country doesn't have to worry about accelerating its rate of economic growth; for it the problem of releasing productive forces does not exist. It has adequate capacity to save and invest. Similarly, in spite of the fact that it may have very wide inequalities of income and wealth, the problem of distributive justice is not an urgent one. Generally, the incidence of absolute poverty is very limited in a developed country. The main problem facing a developed market economy is that of instability of income and employment and the tax system should be geared to attack it.

In this connection, the general prescription as provided by Keynesian and Lerner's theories would be that taxation should be used to generate anti-cyclic changes in total expenditure and demand in the economy; they should be pushed up to counteract depression and reduced during boom periods. Keynes had concentrated his attention upon the state of a chronic depression which was to be cured by increasing effective demand. Hence, the Keynesian remedy would be to reduce taxation (for encouraging expenditure in private sector) coupled with a deficit budgeting. More specifically, his approach would imply reducing tax liability of those tax payers who have a high marginal propensity to consume. Lerner's remedy of compensatory fiscal finance would similarly advocate a reduction in taxation during depression and an increase in it during boom. Also taxation in the field of customs duties can be varied to bring about desired changes in the balance of trade of the country. Care should however be taken to use these duties after considering the elasticities of supply and demand of the affected export and import items.

The above prescription gets modified in the context of balanced budget multiplier. According to the balanced budget multiplier, an expansion (contraction) of the budgetary expenditure, even though fully balanced by increased (reduced) taxation would be expansionary (contractionary) in effect. This implies that a depression can be remedied even by increasing taxation provided public expenditure is also increased correspondingly; similarly, a boom can be cured by

a reduction in taxation provided public expenditure is also reduced by the same or larger amount. These remedial measures assume that a developed economy is competitive enough with adequate factor mobility. To the extent that these conditions are not satisfied and the economy is not able to adjust itself quickly, taxation loses its ability to act as a weapon of stability. In recent years, developed market economics have started acquiring numerous rigidities originating from monopoly elements in manufacturing and trading sectors, strong and militant trade unions and so on. The result is a stickiness of wage rates on the one hand and monopoly profits on the other. Such economies are now witnessing the phenomenon of coexistence of stagnation of demand, unemployment and inflationary pressures. Taxation by itself is not able to eradicate these rigidities and to that extent any tax policy would fail to cure either inflationary price rise or stagnant demand and unemployment. For effective remedies, measures other than taxation would have to be resorted to.

Objectives of Taxation in Underdeveloped Countries (with special reference to India). In this case the primary objective is not that of instability of income and employment. Instead such a country faces a number of problems connected with economic growth on the one hand and removal of poverty and inequalities on the other. In India, we have the additional problem of chronic unemployment and regional disparities also. The above considerations enable us to lay down certain objectives which the tax policy in a country like ours should try to pursue. We may start with the view that such an economy must try to come out of its vicious circle of poverty and that the government and public sector have to play an active role in this task. It may be noted that the problem of growth, by itself, covers numerous aspects and the tax system may be designed to help the economy in more than one ways. Thus, an underdeveloped country faces the problem of insufficient savings and capital accumulation. There is a need to promote specific products to fill both the supply and demand gaps. Social overheads have to be created and maintained, and key and basic industries must be developed to provide a foundation for the industrialisation of the economy. Removal of regional disparities necessitates the promotion of agricultural and industrial development in backward areas of the country. There is also a continuous need to restrict unnecessary imports and promote import tsubstitution and exports.

Accordingly, the government would have to pursue a tax policy designed to curb unnecessary and conspicuous private consumption and yield increasing revenue to the government. Therefore, from

the point of view of total resource availability to the authorities, the tax system shou'd conform to the criteria of buoyancy and elasticity. There will have to be an increasing coverage of the tax net in both direct and indirect taxation. However, it must be noted that there is no definite proportion between the two components which may be considered optimum here. Of course, in our country, for various reasons, indirect taxation would have to provide a predominant proportion of the total tax revenue. But this fact should not deter the authorities in pursuing certain other objectives simultaneously. For example, since indirect taxation is patently pro-inflationary, inputs and intermediate goods should be exempted or should be taxed only nominally. Similarly, in order to subserve the objective of equity, luxuries and articles of conspicuous consumption should be taxed heavily while necessities should generally be spared and some articles of mass consumption may be taxed only at low rates.

Equity and resource mobilisation considerations also dictate that the tax burden should be evenly distributed as between sectors and as between individuals. In India, for example, agricultural sector is taxed lightly compared with non-agricultural sectors. Over 40% of our national income originates in agriculture, but its contribution to the tax revenue is quite small. Equity demands that the rural rich should be subjected to greater tax burden than at present. Similarly, as between individuals, taxation should be highly progressive. In terms of legal provisions, they are so in India, but on account of large scale tax evasion, they are not sufficiently progressive in effect. To be more precise, the whole tax system, as it operates in practice, is highly burdensome for the honest tax payer and favourable to the tax evader. Given this fact, we should emphasise that the impact of direct taxation at the margin should be minimized. Exorbitant tax rates at the margin militate against earning of income and savings, unless the tax payers succeed in large scale tax evasion. Such a state of affairs creates an unhealthy situation in which the parallel or black economy assumes ever-increasing importance.

The tax system should be so designed as to promote private savings on the one hand and direct them into investment in priority industries on the other. Various exemptions and rebates should be incorporated in direct taxes which can be availed of through contributing to savings. Regarding promotion of investment along priority lines, a host of measures can be adopted provided the priorities are decided unambiguously. Thus apart from general tax concessions (like tax holidays and initial depreciation allowance etc.) for raising the level of investment in the economy, investment in specific lines can

be encouraged through additional tax concessions. These additional concessions can be used for accelerating the pace of import substitution, for investment in priority industries and in backward districts. Further, tax concessions may be used for encouraging the use of labour intensive techniques which would help in solving our unemployment problems. Some economists like Enke (*Economics for Development*, Prentice-Hall, 1963, p. 248) maintain that even in a developing economy tax system shou'd be neutral as regards its effects on resource allocation. Carter Commission says that a tax system should not extend tax concessions to particular types of incomes. But these views are based on the assumption that the market allocation of resources reflects the true needs and growth priorities of the society. This is generally not so in an underdeveloped country. Moreover, irrespective of what the theory may say, even direct taxes are not neutral between resource allocation. Instead of leaving resource allocation to the vagaries and whims of market forces, it is preferable to use the tax instrument to divert the same along desirable lines. Taxes can be used to alter the consumption pattern of the households, techniques of production, and relative profitability of various investments. Depending upon the elasticities of demand and supply of various imports and exports, customs duties can be used to remedy balance of trade, curb unnecessary imports and encourage import substitution.

The tax system of developing country should not ignore the limitations of its administrative machinery. Thus we may find that theoretically VAT is an ideal form of indirect tax, but if it cannot be adopted under present conditions, we should sett'e for another form. Similarly, expenditure tax may score over income tax in theory, but its adoption must be decided only after ascertaining the administrative capability of the tax machinery. It is damaging to have a tax which cannot be administered. Again, there mav be certain taxes which are expected to grow in importance with the passage of time and economic growth. It may be that at present they cannot yield adequate revenue, but if they are likely to present extreme administrative difficulties later on, they should be introduced now. There should also be a continuous effort to maintain the simplicity of tax laws to the extent feasible.

It may be noted that it is not an easy task to introduce an optimum tax structure in an underdeveloped country like ours. Thus, as we have noted above, there is an inevitable conflict between refined policies and the ability to execute them. Various characteristics and institutions of an economy may come in the way of adopting an ideal tax system such as the paucity of data, level of education, cultural patterns

etc. A tax system has to be a politically acceptable one and has to be in conformity with administrative capabilities of the authorities. Moreover, several taxes tend to work at cross purposes. An equitable and progressive tax system is likely to be a disincentive for saving and capital accumulation. A system of capital gains discourages building up of specific capital assets. A country like India suffers from the characteristics of what is called a dual economy. This also poses its own problems in devising an efficient and optimal tax structure.

From the above discussion, we can easily see that there is a case for commodity taxation in a country like ours, but this taxation should be *selective*, both with regard to coverage and with regard to rates. The need for a selective commodity taxation follows from the need for resource mobilisation on the one hand and the considerations of equity on the other. At the same time, the tax pattern must recognize the administrative limitations and commodity taxation should be the one which can be administered effectively. Similarly, the inflationary nature of commodity taxation should not be lost sight of. This implies that taxation of capital goods, raw materials and other intermediary goods should be avoided since they have a cost-cascading effect. Commodity taxation should therefore concentrate on final consumption goods only and there also the rates and coverage should be highly selective. While luxuries and articles of conspicuous consumption should be taxed highly, articles of mass consumption should be taxed at very low rates. Similarly, it should be noted that indirect taxation is considerably effective in its allocative effects. This potenial of indirect taxation can be fully exploited through appropriate choice of commodities to be taxed and the rates thereof.

Direct *vs* Indirect Taxes

Indian tax system relies heavily on indirect taxes. Table 21.1 shows the relative percentage of direct taxes (net) and indirect taxes (net) in the total net tax revenue of the Central Government. (The tax receipts of the States consist of their share in Central taxes and their own tax revenue. Over 90% of the latter category consists of indirect taxes like sales tax, excise duties, registration and stamps, electricity duties, entertainment tax, motor vehicles tax etc.) It is seen that with the progress of planning, reliance on indirect taxes increased and has hovered around 75%. And if we take gross tax revenue, the weightage of indirect taxes would appear to be still more. An important reason for this trend is the rapidly rising financial requirements of the Government compared with a limited scope to raise direct tax revenue.

Per capita income in India is quite low and there are large inequalities of income and wealth. The result is that only a small fraction of the Indian population comes within the net of direct taxes. The number of income tax-payers is quite small and that of wealth tax-payers quite negligible. The two most important sources of direct tax revenue are income tax and corporation tax while gift tax and wealth tax are able to provide only a small amount The yield from expenditure tax was very close to zero. The rates of direct taxes are highly progressive. As such the scope to increase yield from direct taxes has remained a limited one. Actual yield from direct taxes, therefore, did not increase as fast as the growth in national income and economic activity would permit, more so because of large scale tax evasion. Moreover, there is a large scale evasion of personal direct taxes. The yield from income tax has not increased as rapidly as that from the corporation tax. Thus, one may conclude that basically the yield from direct taxes can be expected to increase either through increased economic activities or through plugging the tax evasion.

Indirect Taxes, on the Other Hand, Stand on a Different Footing. *Firstly*, they can be used to spread the tax net wider so that everyone makes a contribution to the cause of nation-building. *Secondly*, they are easier to impose and their rates can be revised with comparative ease. An important reason for a rapid increase in indirect taxes lies

TABLE 21.1

DIRECT AND INDIRECT TAX REVENUE OF THE GOVERNMENT OF INDIA

(*Rs in crores*)

Period	*Direct Taxes (net)*	*%age to Total Tax Revenue*	*Indirect Taxes (net)*	*%age to Total Tax Revenue*	*Total Tax Revenue (net)*
1950-51	129.5	22.9	277.5	77.1	357.0
First Plan	600.6	30.4	1372.9	69.6	1973.6
Second Plan	869.0	29.1	2125.7	70.9	2994.7
Third Plan	1949.9	29.3	4708.2	70.7	6658.1
Annual Plans	1505.6	25.5	4383.9	74.5	5889.5
Fourth Plan	3229.6	21.6	11689.1	78.4	14918.7
1974-78	5978.9	24.2	18769.0	75.8	24747.9
1978-79	1841.9	21.5	6726.4	78.5	8568.3
1979-80	1914.1	23.3	6304.6	76.7	8218.7
1980-81	2078 4	23.8	6646.6	76.2	8725.0

Source: RBI Bulletin (Various Issues) and Explanatory Memorandum on the Budget of the Central Government, 1975-76 to 1980-81.

in their wider coverage from year to year as also upward revision of many tax rates. Since excise and customs duties are in several cases on an *ad valorem* basis, the yield from them has been elastic not only with respect to increased economic activity, but also with respect to price changes. *Thirdly*, with a proper and judicious selection, indirect taxes can also be made progressive. To this end, luxuries and goods of conspicuous consumption should be taxed heavily while goods of mass consumption can be taxed at low enough rates. It may not be possible to introduce enough progressivity in the tax system if reliance is had on direct taxes only. The extent of steepness in the required progressivity is likely to act as a damper on productive efforts. Therefore, progressivity of direct taxation should be supplemented with that of indirect taxation. Moreover, unless the basis of direct taxation is shifted from income and wealth to expenditure, it is not possible to curb conspicuous, unnecessary and wasteful consumption by the richer sections. Therefore, indirect taxation becomes an essential element of a balanced tax system. *Fourthly*, indirect taxation can be a powerful instrument through which the resource-allocation of the economy can be influenced. An appropriate set of indirect taxes with appropriate rates may be designed so as to encourage investment in priority industries and labour intensive industries, to promote import substitution and help exports and the like.

But there is a need to reform the existing indirect taxation in India. The practice of taxing inputs and intermediate goods has had the cost-cascading effects and increasing (and repeated) tax liability at different stages of production. (Incidentally, inflationary trends have helped the government in raising larger amounts of revenue from indirect taxes.) Similarly, there also exists the obnoxious practice of levying octroi duties and terminal taxes by local bodies. Means should be found to compensate the local bodies to relieve them of the necessity of levying octroi and terminal taxes Similarly, though it is not feasible to introduce VAT, steps should be taken to concentrate indirect taxes on finished goods only and avoid the taxation of inputs and intermediate goods as suggested by the Jha Committee.

It is implied in the above discussion that commodity taxation in India ought to be selective in character in order to achieve the above mentioned objectives and meet other criteria of a good tax system. This is more so in the absence of the VAT. VAT, in its ideal form is a non-selective form of commodity taxation; a VAT which is selective in its coverage and rates, providing various exemptions and sets of rates is highly difficult to administer and not very suitable to the administrative capacity of an underdeveloped country like ours. For our

economy, planning and growth policies include certain definite objectives. A given commodity tax is likely to have more than one effect in the economic system. And to that end, commodity taxation has to be selective in both coverage and rates.

It is generally felt that the division between direct and indirect taxes may have met the revenue objective of the Government, but it has not reduced inequalities of income and wealth. The forces contributing to inequalities are far stronger. The avenues and possibilities of adding to incomes and wealth have been favourable to the richer sections of the society. Moreover, there has been a good deal of tax evasion in both direct and indirect taxes, and this has also added to the inequalities since the evasion of indirect taxes also goes into richer pockets. Furthermore, in themselves indirect taxes are mostly regressive and there has been a greater reliance on indirect taxes. Actually in the field of direct taxes a few measures are believed to have contributed to income inequalities. These measures include tax concessions for industrial growth and incentives in the form of import entitlements. Whatever contribution budgetary policy is to make towards reducing inequalities, has been made mainly through public expenditure. Any undue reliance on indirect taxes for this purpose is not likely to be practical so long as we rely upon market mechanism and free enterprise for economic growth. Moreover, for revenue reasons, a large number of items have to be taxed which make the indirect tax system as a whole regressive. It is felt that relatively low incidence of tax on agriculture has also contributed towards increasing the reliance of authorities on indirect taxation. Agriculture accounts for a very large chunk of our national income, but the tax revenue from this source is not commensurate with its growth. Agricultural income can be taxed only by States and is taxed only marginally. The fact that agriculture has not been taxed sufficiently both directly and indirectly is forcing both State and Central Governments to concentrate their tax effects on industrial and services sectors and the commodity taxation has been pushed up more than proportionately.

COMMENTS ON INCOME TAX AND CORPORATION TAX

Income Tax. According to our constitution, taxation of agricultural income is reserved for the States, while the Central Government levies tax on non-agricultural incomes only. Furthermore, the net proceeds of income tax are to be shared with the States. The percentage share going to States, as also the shares of individual States *vis-a-vis* each other, are decided on the recommendations of the Finance Commis-

sion. In India, in addition to the income tax proper, there has been a super tax on incomes exceeding a certain limit, and various surcharges. One can mention, for example, the Surcharge (Union), Surcharge (Special), and Additional Surcharge (Union). The income tax which is imposed on corporate incomes has been variously called super tax or corporation tax.

Income tax was introduced in India in 1860 but was discontinued after a few years. It was reintroduced in 1886 and it has stayed in the Indian tax structure since then. In 1939, the rate structure was designed on a 'slab system' and the rates and exemptions have changed extensively since then. Indian personal tax is quite a complicated set up, admitting of distinctions between earned and unearned incomes, regular and irregular receipts and in terms of various exemptions, rebates, allowances, surcharges, and the like. These measures were introduced under various considerations. On the recommendations of the Taxation Enquiry Commission, an element of family allowances was introduced by making a distinction between married and unmarried tax-payers. The scheme in due course incorporated children allowance, dependent parents allowance, children's education allowance etc. Similarly, certain incomes like house rent allowance were partly or wholly exempted from income tax but others like dearness allowance were treated differently. In the same manner, certain receipts like gratuity, provident fund, etc. are treated differently from one's regular income. To encourage savings, rebates and exemptions are provided on them. To encourage investment in certain lines, income from certain investments is not taxed up to a limit.

The rates of income tax have also seen frequent changes. Thus, in 1951-52, income tax touched a maximum rate of 25%, while super tax went up to 53.1%. In addition to that a surcharge of 5% was also levied on both income tax and super tax. In subsequent years, adjustments in basic exemption limit and rates were introduced. In 1956-57, the tax rate for the slab of over Rs 1.5 lakhs was raised to 91.8%, but in 1957-58, it was again brought down to 85% on unearned incomes and 77% on earned incomes. In 1965-66, income tax structure was partially rationalized by integrating income tax and super tax into one unified tax. Now the Surcharge (Special) stands abolished and consequently its yield declined from Rs 9.0 crores in 1974-75 to only Rs 1.0 crores in 1975-76 (BE). The exemption limit has been gradually raised in view of the rising price and now stands at Rs 10,000. The income tax rate, inclusive of surcharge, which had been raised in stages to 97.75% for the highest income slab, was sought to be reduced on the recommendation of the

Wanchoo Committee. It was argued that too high a rate was tempting the tax payers to attempt evasion. In the budget for 1975-76 it was reduced to 77% inclusive of surcharge. Finding no reduction in the collection of tax revenue, it was further reduced to 66% inclusive of surcharge in the budget for 1976-77. In 1977-78, however, the Union surcharge was increased to 15% of the tax and in 1979-80, to 20% raising the effective highest rate to 72%. Frequent and bewildering changes have been taking place in certain other aspects of income tax also. For example, the way in which Hindu Undivided Family is treated *vis-a-vis* an individual tax payer has been modified quite frequently. Similarly, there have been year-after-year changes in the rates and provisions of exemptions designed to encourage savings or particular types of investments, etc. Areas of wealth tax, capital gains tax, compulsory deposit scheme and the like have also been subjected to quick changes.

An important change in income tax structure is the partial integration of agricultural and non-agricultural incomes since 1973. This step was taken in the wake of the Raj Committee's recommendations to this effect. The Committee found that while the Central Government could not tax agricultural incomes without an appropriate amendment of the Constitution, the Centre could levy a higher liability upon those tax-payers who had agricultural incomes as well. Moreover, this step was considered necessary for plugging the tax evasion on non-agricultural incomes by showing them as agricultural ones and also to impart an element of equity in the personal income tax. By this partial integration of the two types of incomes, the non-agricultural income of a tax-payer is pushed to higher tax slabs and attracts a larger tax liability. However, this step does not bring in complete equity between different tax-payers. If a person does not have taxable non-agricultural income, he is not liable to pay income tax on his agricultural income also (unless the concerned State Government is levying an agricultural income tax).

Corporation Tax. A company in India is subject to both what we call an income tax and a corporation tax which is also named super tax. A corporation tax is the tax on company's own income, while the income tax is the tax which the company deducts at source from the dividend payments on behalf of its shareholders. The net dividend which a shareholder gets from the company is, therefore, after the deduction of an income tax which is adjusted against his finally assessed tax liability. The super tax on companies, that is the corporation tax proper, is levied at a flat rate but is subject to a number of rebates, exemptions, and so on. Inter-corporate dividends are

distinguished from other corporate profits, and companies are also classified in terms of size and nationality (Indian and foreign). Over the years, a large number of economic objectives have been advocated by various committees, experts and thinkers and it has been a practice on their part to recommend tax incentives for the purpose. The result is that now we have quite a complicated structure of corporation tax. Exemptions and rebates vary and are related to different activities, criteria and types of corporate incomes, profits, investments and the like.

For example, a development rebate was introduced in 1955 in place of an initial depreciation allowance which till then had been allowed at the rate of 20%. The new development rebate was at the rate of 25% of the cost of all new plant and machinery, though for specified essential articles it was 35% and for ships it was 40%. The net effect of this provision was that a company was able to get a total deduction of 125 to 135% of the initial cost of installing the machinery over its lifetime. Though the development rebate could be enjoyed subject to certain conditions, a voice was raised about its desirability in our company tax structure. In 1970-71, the rates of development rebate were reduced from 35 to 25% in the case of priority industries and from 25 to 15% in the case of other industries. It was finally abolished with effect from 31 May 1974 except in the case of ships ordered before 1 December 1973 and delivered by 1 January 1977. The development rebate was replaced by an initial depreciation allowance which was 20% of the cost of machinery and plant. It was allowed to the priority industries listed in the Ninth Schedule to the Income Tax Act. The budget for 1975-76 extended this benefit to pesticides industry also. The budget for 1976-77 introduced *investment allowance* which replaced the scheme of *initial depreciation allowance* and is broadly on the lines of the *development rebate* that was (as mentioned a little earlier) discontinued and had been replaced by an initial depreciation allowance. In this scheme, a deduction of 25% (as against 20% in the case of initial depreciation allowance) is allowed on particular investments and under particular conditions.

Another incentive for the growth of the new industries is the tax holiday, which was introduced in 1957-58. Companies enjoying this benefit are exempted from tax liability on profits up to 6% p.a. of the total capital employed. To begin with this tax holiday was allowed for only five years. In 1971-72, the definition of 'capital employed' was restricted to exclude debentures and long-term borrowings. The 1975-76 budget extended the tax holiday for industrial

undertakings going into production before 1 April 1976 and ships brought into use before that date for another five years. Similarly, in 1957-58 a new concept was introduced by which dividend income received from an Indian subsidiary was subjected to a concessional rate of 10% of the corporation tax. The budget for 1975-76 provided for an exemption of inter-corporate dividends from new companies engaged in high priority industries (namely, manufacture of fertilizers, pesticides, paper and cement) and exemption from wealth tax on equity shares in new companies engaged in certain priority industries. Tax holiday was denied to non-priority industries in 1979-80.

Still another incentive in our corporate taxation is the one based upon export promotion. Prior to 1978-79, the companies were allowed a weighted deduction in the computation of taxable profits with reference to certain expenses (if they were not in the nature of acquiring assets abroad) if such expenses were incurred for promotion of exports, or the supply/distribution of goods outside India. The weighted deduction was at the rate of 150% in the case of widely-held companies and at the rate of 133.3% in the case of other tax-payers. The budget for 1978-79 abolished this system of weighted deduction, but was reintroduced in 1979-80. Similarly, another set of incentives exists for the encouragement of capital formation by the corporate sector. This includes a concessional taxation on small companies and inter-corporate dividends, taxation of excess dividends and on bonus shares. The budget for 1978-79 provided a tax concession for investment in equity capital of new companies, but at the same time withdrew concessions for capital gains tax if the sales proceeds were invested in bank deposits or equity capital of existing companies. The concession in capital gains tax was totally withdrawn in 1979-80.

It is obvious that the existing corporation tax system is in need of a simplification. There are many contradictory tax provision. Some try to encourage investment in corporate sector, others have the effect of nullifying these incentives. Certain measures designed to check various malpractices have also the unintended effect of hindering capital formation in the corporate sector. It is assumed that the corporate sector is responsive to various tax measures and various economic objectives can be promoted through an appropriate set of tax measures But the efficacy of these tax measures is not certain. Apart from the fact that various tax measures are sometimes contradictory, the private sector has a tendency to abuse the tax concessions. For example, certain unnecessary and undue expenses by a company are discouraged by not allowing them as deductible expenses

for the purposes of arriving at taxable income. But the provisions in this regard have been found vague and the companies have found it possible to extend large benefits to the directors and privileged employees. While in the case of an individual tax-payer, the deductible expenses are those which are absolutely necessary and *unavoidable* for the purpose of employment, in the case of a company the deductible expenses are those which are necessary for *the purpose of the business.* The companies are able to take advantage of the provision put like this and are able to go ahead with a lot of undue expenditure on office buildings, office facilities, and the like.

There have been too frequent changes in the corporation tax and as a result the effect of different tax measures are not properly known. The changes have been more in the nature of experimentation, and that too, on a short-term basis, than in the nature of evolving a long-term unified policy. This approach has come in the way of an effective and efficient tax administration with the consequent loss of revenue to the government. At times, suggestions have been made to simplify the corporate tax structure to make it more effective and purposeful. One such suggestion is to change the very basis of corporate taxation from income or profits to expenditure.[1] Choosing corporate profits as the basis for determining the tax liability has many disadvantages. This approach taxes efficiency (by imposing a tax on profits) and subsidizes inefficiency (by permitting losses to be carried forward). It is stated that in this approach, the States becomes a partner of the company owners in sharing losses by foregoing its tax in that and in future year/years. Since extra expenses cut into profits (or increase losses), therefore, the companies find that in effect they bear only a part of the additional expenses. They are under an incentive to show that their profits are low or even zero and to inflate expenses. Personal expenses of the directors and privileged employees are camouflaged as business expenses. To this are added the unnecessary and avoidable expenses of posh office buildings and the like. All told, there is a built-in incentive for the companies to run in an uneconomical manner which is equally bad for the economy as a whole since its scarce resources are to some extent wasted. And another major defect of this system is that it favours the financing of company's activities through borrowing instead of through equity capital. The interest

[1]See Gulati and Bagchi. "A Proposal for Reforming Corporation Tax," *Economic and Political Weekly*, Annual Number, February 1975, pp. 195-204. Also V.D. Lal, "Changing the Corporate Tax Base,' *Economic and Political Weekly*, 22 March 1975, pp. 531-34.

payments on borrowings are deductible expenses while dividend on equity is a residual item. To the extent that funds are utilized by a company in the form of a loan rather than equity capital, the government loses a portion of the tax revenue. Lall says that "it is an interesting phenomenon in the Indian corporate sector, that companies continue to exist in spite of growing accumulated losses, as a result of continuous negative profits for years together." Referring to another study of his which covers some 3200 companies he says that in a very large number of cases the accumulated losses far exceeded their share capital as well their net worth. It is generally believed that the main aim of the companies is not to earn profits but to benefit the directors and their friends and relatives etc., through various means like contracts, advertising, selling agencies etc.

To choose gross profits (before tax and interest) would certainly be better than choosing net profit as the tax base. But it would not be able to remove many other defects and would not be able to ensure an economical use of the resources of the economy. Gulati and Bagchi recommended that the base of corporate taxation should be the expenditure other than the one on labour. Lall is, however, doubtful about the effectiveness of this cure. He feels that the controllers of the companies would still be able to operate for personal gains through avenues like sale and distribution, publicity, repairs, travelling, conveyance, consultancy and so on One may add that with the adoption of the new base, there will be a tendency to underinvoice purchases to reduce the taxable expenses and some of the expenses on research and development will be avoided. All told, it appears that choosing the expenditure as the tax base has its own disadvantages and complications, but the need for a simplified tax structure cannot be ruled out.

There is a renewed thinking in the USA and India on the desirability of having a unified direct tax system. The government of India appointed in June 1977 the Direct Tax Law Committee under Shri Palkhiwala (later headed by Shri S.C. Chokshi) to recommend: (*a*) measures to simplify and rationalise the direct tax laws; (*b*) methods of improvement of the administration of the laws; and (*c*) advisability of consolidation of the laws. The Report of the Committee contains certain procedural reforms. It should be possible to bring about substantial and helpful reforms in the system of direct taxation in the light of the recommendations of this Committee.

THE PROBLEM OF TAX EVASION

The problem of tax evasion and avoidance is one of the most serious ones of our tax system. Tax avoidance is distinguished from tax evasion in the sense that tax evasion is an illegal way of avoiding tax liability while tax avoidance is avoiding tax liability by taking advantage of loopholes in the tax laws. Tax evasion is a fraudulent practice, though both tax avoidance and tax evasion are immoral and in both cases the government loses revenue.

Estimates of tax evasion have varied quite widely. The Taxation Enquiry Commission estimated the evasion of income tax at Rs 50 crores. Kaldor estimated that between Rs 200-300 crores were being evaded, while the Direct Taxes Administration Enquiry Committee put the figure at barely Rs 20-30 crores. All these estimates show that the extent of tax evasion is anybody's guess. But one thing is certain. With the passage of time, the growth of economy, complexity and variety of taxes, tax evasion has certainly increased to a very large extent. And evasion of tax is not confined to only direct taxes. Indirect taxes are also being evaded very extensively whereby both the consumers and the Government lose. For example, in 1968, the Government introduced the 'Self-Removal Procedure' for simplification of the system of collection of Central Excise Duties. In September 1971, a Central Excise (Self-Removal Procedure) Review Committee was appointed under the chairmanship of B. Venkatappiah to assess the working of the new scheme. The Committee was "painfully surprised at the range, diversity and in certain segments of production, almost the universality of the evasion which is practised by those who produce the goods."[2] It may be noted that the growing complexity of our tax laws is partly due to certain inherent tendencies connected with an expanding tax system. The authorities, however, have realised the need for simplifying our tax structure, especially the indirect one. The Finance Minister in persuance of his promise during the Budget Session of Parliament in 1976, constituted the Indirect Taxation Enquiry Committee in July 1976 with the task of a comprehensive survey of the whole indirect tax structure and for making suitable recommendations. A similar committee was later constituted for direct taxes also.

The reasons for tax evasion are many and interdependent. In some

[2]Central Excise (Self-Removal Procedure) Review Committee, *Report*, 1974, para 10.9.

circles it is believed that in India high rates of direct taxation are basically responsible for large scale tax evasion. This is not so. High rates only make the tax evasion more tempting. The tax evaders are ready to take greater risks if they find that in the event of success the reward is high. This was one of the arguments given by Kaldor for reducing the tax rates in the upper slabs. But high tax rates by themselves do not explain all the tax evasion. There have to be opportunities also to this end. Given the scope, taxes will be evaded even at lower rates, since in general nobody likes to pay taxes. Thus even in the case of indirect taxes like sales tax, excise duties etc. where the incidence can be mostly shifted to the purchasers, the sellers resort to tax evasion if they can. This practice helps them in increasing their own incomes by cheating the Government of its legitimate revenue. Thus, we may conclude that large scale tax evasion is basically the result of opportunities to evade tax though high tax rates strengthen the desire for this malpractice.

Opportunities for tax evasion emanate from many sources. Our economy is yet an underdeveloped one and there are information gaps at all levels. Appropriate accounts are not maintained by most individuals and even by most farmers and small businessmen etc. Since even the bigger business firms deal with these sections of the society, a part of transactions of even bigger firms (which maintain accounts) cannot be cross-checked. This enables many tax-payers in concealing or twisting the factual information and thus evading taxes. Actually quite a number of potential tax-payers just do not come to the notice of the tax collecting authorities. Such concealing or misrepresentation of facts is not limited to the field of direct taxes. Production and sale of commodities and services are also concealed and the Government cheated of the yield from indirect taxes.

Another opportunity for tax evasion comes to the way of tax dodgers in the form of complicated tax laws. More accurately, taking advantage of the loopholes in tax laws would amount to 'tax avoidance' rather than 'tax evasion.' Anyway, as it is, our tax laws are highly complicated with a host of exemptions, rebates, concessions, surcharges and so on and in the light of insufficient information on the working of the tax paying economic units, a state of confusion arises. For example, the Central Excise (Self-Removal Procedure) Review Committee found that there were nearly 1,000 live notifications by virtue of which duty reliefs were offered. It also found that there were about 300 tariff rates which, as a result of the issue of notification of exemptions, had multiplied into more than two thousand effective rates. With rapidly changing tax provisions

and the details therein, even the tax officials are not always able to see the tricks which the tax-payers might be playing. The authorities have counteracted this tendency by giving wide powers to the tax officials, but this quite often leads to undue harassment of even the honest tax-payers who might be treated the same way as the dishonest ones.

Investments in real property (movable and immovable), concealing their true ownership and benefits including price appreciation, and capital gains would constitute another set of devices for tax evasion. This happens more so through benami holdings, bearer bonds and blank transfers of shares. Absence of a comprehensive reporting system on income, wealth transactions and benefits of a tax-payer provides a source of misrepresentation of the facts and cheating the authorities. To this may be added the imperfect tax administration. Tax officials are not always the best trained or most efficient and like other human beings are sometimes found amenable to various temptations. Wanchoo Committee[3] points out that a system of shortages, controls and licences also breeds tax evasion and black money. The Committee also lists donations to political parties as another factor in the same process.

It goes without saying that the evil of tax evasion should be eradicated from the country. Amongst various advantages, it will enable the authorities to raise additional resources without corresponding increase in tax rates or spreading the tax net. It may even be possible for the authorities to lower certain tax rates. If tax evasion is there, the tax system is always likely to lack adequacy and buoyancy which are two of the basic features of a good tax system. Furthermore, tax evasion breeds black money which creates its own parallel economy. Black money distorts the demand and supply position of various items in the country and thwarts the attempts of the authorities at effective planning. Their efforts at regulating the economy are also neutralized. Artificial scarcities are added to the genuine ones and inflationary pressures are strengthened and effectiveness of Government's fiscal and monetary measures is either lost or reduced. The productive resources of the economy are diverted into less desirable and sometimes even undesirable channels. It causes a considerable amount of leakage of foreign exchange through shady foreign trade deals, and also through wrong invoicing, secret cuts and commissions on joint ventures and collaboration agreements involving Indian and

[3]Direct Taxes Enquiry Committee, *Final Report*, 1971, para 2.20

[4]*Ibid.*, para 2.7.

foreign parties.[4] Moreover, as tax evasion increases, the tax burden on those who are paying the taxes has to move up in order to provide as much revenue to the Government. All told, the effects of tax evasion and black money can only be termed disastrous.

Various proposals have been put forth from time to time for checking the evil of tax evasion. One such important set of proposals is found in the *Indian Tax Reform—Report of a Survey* by Nicholas Kaldor in 1956. Although Professor Kaldor was primarily invited to review the personal and business taxation in the Indian tax system in the context of larger resource requirements of the Second Plan, he dealt with the problem of evasion of direct taxes and suggested remedies for the same. Kaldor found that the Centre and State taxation was a little over 7% of the national income and that tax revenue was not a buoyant one, that is, it was not showing an automatic increase along with the increase in national income. According to Kaldor, the direct tax system in India had many defects. "The present system of direct taxation in India is both inefficient and inequitable. It is inequitable because the present base of taxation, 'income" as statutorily defined is defective and biased as a measure of taxable capacity and is capable of being manipulated by certain classes of tax-payers. It is inefficient because the limited character of information furnished by tax-payers and the absence of any comprehensive reporting system on property transactions and property income makes large scale evasion, through concealment or understatement of profits and property income relatively easy."[5]

While proposing his scheme of tax reforms, Kaldor emphasised the need to have appropriate conceptual definitions of income etc. This would ensure simplicity and certainty and thereby reduce the scope for tax evasion. Furthermore, he wanted a two-pronged attack on the problem, viz., reducing the incentives for tax evasion and providing greater obstacles in its way. Kaldor believed that with a high marginal income tax rate of 97%, if a person conceals Rs 100 of his income, he is rewarded by Rs 97. This view was also substantiated by most of the economists, professors, departmental officers and others who testified before the Wanchoo Committee. Trade and industrial bodies expressed a unanimous view before the Committee that such high tax rates breed black money and tax evasion.[6] "When the marginal rate of taxation is as high as 97.75 per cent, the net profit on concealment can be as high as 4.300 per cent of the after tax

[5]Nicholas Kaldor, *Indian Tax Reform—Report of a Survey*, 1956, p. 1.
[6]Direct Taxes Enquiry Committee, *Final Report*, 1971, para 2.20.

income. The implication of 97.75 per cent income tax is that it is more profitable at a certain level of income to evade tax on Rs 30 than to earn honestly Rs 1000. We will not be surprised that placed in such a situation, it would be difficult for a person to resist the temptation to evade taxes.[7] Kaldor asserted that if the tax rates are reduced, people will be less ready to incur expenditure and take risk of tax evasion because the corresponding reward in the event of success will be smaller. He therefore, recommended that income tax at the margin must be reduced to 45% or below. Similarly, the companies should be subjected to a flat rate of 45% tax on all profits in place of the existing income and corporation taxes.

The set of proposals to put hurdles in the way of tax evasion included the supplementing of income tax with four more taxes, viz. capital gains tax, annual tax on wealth, personal expenditure tax, and gift tax. Such a composite tax system was designed to ensure that a tax-payer was not able to evade tax liability by camouflaging or concealing his economic activities or the results thereof. Furthermore, he wanted a comprehensive return concerning the personal accounts of each tax-payer and the introduction of a reporting system of all capital transactions by means of tax vouchers. For the latter purpose a national register was to be maintained. He believed that a comprehensive return along with a multiplicity of direct taxes and the national register would reduce the scope for tax evasion through falsification of accounts. An effort to save some tax liability in one direction would result in an enhanced tax liability in the other, or the tax liability of some other tax-payer would have to increase (in which case the other tax-payer would not permit such falsification by the first one).

All these steps, however, would not ensure a complete plugging of tax evasion. Firstly, the proposals covered only direct taxes, and secondly, because all individuals are not tax-payers. Kaldor therefore recommended some additional steps to help the tax authorities in toning up the tax machinery. Kaldor suggested that the tax-payers whose incomes exceeded a certain limit must be made to have their accounts compulsorily audited with the statutory obligation on the chartered accountants to examine whether the accounts presented were drawn up in an appropriate manner so as to show the true chargeable income for tax purposes. He recommended that each tax-payer should be supplied with a code number[8] and it should be

[7] *Ibid.*, para 2.20.
[8] Kaldor, *op. cit.*, p. 53.

obligatory in the case of all property transfers to disclose the code number of the transferor and the transferee. And all these steps were to be supplemented by a system of deterrent punishment in the case of detection of tax evasion.

The Government introduced the taxes as recommended by Kaldor, but did not accept most other recommendations. Code numbers to tax-payers were not allotted, the system of a comprehensive single return was not adopted. A national register for recording the property and capital transactions was not introduced and the marginal rates of taxation were not reduced. The recommendation regarding the compulsory auditing remained on paper. And in the absence of these additional measures, the introduction of additional taxes did not reduce the evil of tax evasion.

In June 1958, the Government appointed the Direct Taxes Administration Enquiry Committee under the chairmanship of Shri Mahavir Tyagi with the specific objective of "implementing the integrated scheme of direct taxation with due regard to the need for eliminating tax evasion and avoiding inconvenience to the assessees." Strangely enough, a number of suggestions made by Kaldor for plugging the tax evasion did not find favour with this Committee. For example, the Committee did not favour the idea of a comprehensive single tax return. Instead it suggested a few changes in the administrative procedure and wanted the authorities to enlist public cooperation in tax evasion. The evil of tax evasion, obviously, continued unabated.

In 1967, the Central Government asked Mr Bhoothalingam to examine the question of rationalisation and simplification of the tax structure.[9] In his comprehensive report submitted in December 1967 some administrative changes were recommended while changes in the tax structure included the abolition of Surtax and Dividend Tax, treatment of certain expenses like expenses on market surveys, shifting of factories etc. as capital expenditure, abolition of development and export incentives. It was also recommended that the existing system of taxing the inter-corporate dividends should be replaced by standard tax rates except in the case of dividends from subsidiary companies. The exemption limit in personal income taxation should be raised and family and parent's allowances should be abolished. The distinction between earned and unearned incomes should also be abolished and a uniform tax should be levied on both. While pro-

[9]Ministry of Finance, Government of India, *Final Report on Rationalisation and Simplification of the Tax Structure* (Bhoothalingam Report), 1967.

gression should continue to be there in the case of personal income tax, companies should be taxed at a uniform rate, and the distinction between closely held and other companies should be abolished. In order to discourage an excess use of capital, a tax of 1% on all forms of capital and loans should be levied.

Bhoothalingam Report got a mixed reception. Different sections of tax-payers welcomed the suggestions which favoured them. These recommendations, however, were not effective enough to solve the problem of tax evasion. In 1968, a report of the Working Group of the Administrative Reforms Commission, headed by Mahavir Tyagi, was submitted to the ARC.[10] This report concerned itself mainly with the problem of tax evasion. This report also dealt with various administrative steps to facilitate quick disposal of tax assessments. But it asserted that the provision of some incentive schemes only increased the administrative burden of the tax machinery without corresponding benefits to the economy. It recommended a system of allotment of permanent code numbers to tax assessees. The same code numbers should also be used in transaction with Government departments.

All these enquiries and administrative changes failed to contain the problem of tax evasion. Black money proliferated and led to the development of a parallel economy on a rampant scale. Tax evasion and tax arrears assumed an endemic scale and called for some immediate steps. Accordingly, still another committee, known as Direct Taxes Enquiry Committee was appointed with Justice K.N. Wanchoo, former Chief Justice of the Supreme Court of India, as its chairman. The Committee was to examine the problems of direct taxes with special reference to black money and its proliferation and tax evasion through various legal devices including the formation of trusts. The Committee submitted its final report in December 1971 and made some far-reaching recommendations. It emphasised that tax evasion and black money are closely inter-linked. It noted the fact that over the years the problem of black money had multiplied manifold. It felt that probably the evasion of income tax alone in 1968-69 was of the order of Rs 470 crores. After considering a number of suggestions for fighting the malady, the Committee made many far-reaching recommendations which, in addition to various administrative changes, include the following:

(1) The maximum marginal rate of income tax, including surcharge should be reduced from 97.75% to 75%. Some reductions in the rates

[10]Administrative Reforms Commission, *Report of the Working Group on Central Direct Taxes Administration*, January 1968.

at middle and lower levels should also be made. Companies, whether public or private, widely held or closely held, industrial or non-industrial, should be taxed at a uniform rate of 55%.

(2) To the extent possible all useless controls, licensing and permit systems should be abolished.

(3) Donations to political parties should be regulated. Accounts of the political parties should be audited after each party being registered under the Societies Registration Act, 1860.

(4) The Committee recommended that the Central Government should assume the power to levy and administer tax on agricultural income.

(5) The tax authorities should be able to tax the amount of unexplained expenditure.

(6) To the extent possible, the existing sales tax system should be replaced by additional excise duties.

(7) All persons whose income or business turnover exceeds certain prescribed limits must compulsorily maintain accounts. Similarly, where sales/turnover/receipts exceed certain limits, auditing of account should be mandatory.

(8) An important recommendation which had been made earlier also, viz., allotting a permanent account number to each tax-payer was repeated by the Committee. This recommendation has been implemented also.

(9) Expenditure tax should be reintroduced as a supporting measure to check tax evasion.

(10) The Government should assume powers to acquire immovable properties in case of understatement of value.

(11) The Committee recommended a thorough overhauling and strengthening of the tax administration and intelligence.

(12) The penalty for tax evasion should be related to the tax saved rather than to the income concealed, and the penalty rates should be increased to make them more deterrent.

Most of these recommendations have been accepted. It should be noted that quite a few of the suggestions of the Committee had been put forth by earlier committees etc. and were on record. However, the Kaldorian recommendation of a single comprehensive return can go a long way in checking tax evasion. The Committee also took pains in understanding the problems of administration of the taxes including the personnel of the tax machinery and made suitable suggestions. Seized with the problem and determined to solve it, the authorities are taking various steps to strengthen the tax machinery, rid it of inefficiency and corruption and impose deterrent

punishment upon tax evaders. Furthermore, the marginal rate of income taxation were reduced in the budgets for 1975-76 and 1976-77 to 70% and 60% respectively for the highest income slab. This is of course subject to the surcharge for the purposes of the Union (current rate 10% of the tax). The Wanchoo Committee had recommended the reduction in the maximum marginal rate, including surcharge, from 97.75% to 75%. The reduction to 77% showed that there was no decline in the tax collection on account of this step. Accordingly, a further reduction was introduced in the budget for 1976-77 to bring the marginal rate to 60% plus surcharge.

In January 1978, the Central Government demonetized currency notes of Rs 1000 and greater denominations. The total amount of such notes in circulation was not much and net destruction of such currency amounted to only a few crores. The authorities, however, claimed that these notes of high denominations were being used to finance illegal transactions and their cancellation helped in curbing such transactions to some extent.

It goes without saying that most of the remedies often suggested for checking tax evasion concentrate upon flushing out the existing black money and bringing it in the tax net. Even a voluntary disclosure scheme (*e.g.*, that of 1975) is based upon the same approach. It is obvious that a long-lasting solution of the problem would be found only if the very mechanism by which black money is generated is replaced by something better. It is in this context that the recommendation number (2) of the Wanchoo Committee (listed above) assumes a special significance. The existence of useless controls, licensing and permit systems have a tendency to create an artificial scarcity and provide an opportunity to the private sector to earn income which can be concealed from tax authorities. If a major reliance is placed on fiscal and monetary controls instead, the very source of the generation of unaccounted income would tend to dry up.

VOLUNTARY DISCLOSURE SCHEME OF 1975

Amongst various measures to check the evils of black money (such as lowering the tax rates and even such fundamental changes as fostering private enterprise economy in the place of a mixed economy) was the one which suggested *voluntary disclosure* of black income and *wealth* by the tax dodgers. As it is, the suggestion was not a new one. There had been three schemes of voluntary disclosure earlier also, though they could not be considered a great success. After In-

dependence, a voluntary disclosure scheme was announced in 1951 in which the penal provisions of the tax laws were relaxed to persuade the tax evaders to come forth and disclose their unaccounted incomes. A second scheme of voluntary disclosure was brought into being under section 68 of the Finance Act of 1965. This scheme was popularly known as the '60-40 Scheme' since the tax evaders were to pay 60% of the disclosed income by way of tax and the remaining 40% could be brought into books of account (that is, could be converted into 'white money'). This was followed by another scheme in the same year under Section 24 of the Finance (No. 2) Act, 1965. This scheme was known as the 'Block Scheme', because according to its provisions the tax payable was determined according to the block of income disclosed and not at flat rate of 60%. The results of these three schemes of voluntary disclosure were 'disappointing.'[11] The total, disclosures under the three schemes amounted to only Rs 267 crores, which in the view of the Wanchoo Committee[12] was only a small fraction of the concealed income during the 15 years from 1951 to 1965. Compared with it the Income Tax Department itself detected a concealed income of Rs 161 crores during a period of only five years from 1965 to 1969 and realized a sum of Rs 105 crores by way of tax and penalties. The Committee also pointed out that much of the disclosed income had already been detected or was about to be detected and therefore the schemes did not materially contribute in bringing to the surface additional concealed incomes And if we look at the taxes realized through these disclosure schemes, we find that the tax yield of the '60-40 Schemes' was only Rs 30 80 crores, while the remaining two schemes yielded just about 15% of the disclosed incomes The grand total of the tax yield of the three schemes was only Rs 61.23 crores.

The Wanchoo Committee, while considering the suggestion for another voluntary disclosure scheme, found itself against it. The Committee asserted that such schemes helped the fraudulent people at the cost of the honest and law-abiding tax-payers and this has a demoralizing effect for them. In a number of cases the same set of people had taken advantage of tax concessions under all the three schemes indicating that such schemes did not reform the law breakers These schemes did not tackle the problem of regeneration of black money or the intention to conceal the ill-gotten income and wealth. The

[11]Government of India, Ministry of Finance, Direct Taxation Enquiry Committee (Wanchoo Committee), *Final Report*, 1971, para 2.28.

[12]*Ibid.*, para 2.28.

Committee felt that resorting too frequently to such a measure of voluntary disclosure would shake the confidence of the honest tax-payer and encourage the unscrupulous tax dodger. The tax enforcement machinery would also lose respect in the eyes of the tax-payers. Majority of the departmental officers, some chambers and other representatives of the trading community had also expressed themselves categorically against the introduction of such schemes in future. The Committee also disagreed with the view that voluntary disclosures could be expected to broaden the base of investment and accelerate economic growth since the concealed amounts happen to be, by and large, already invested in a surreptitious manner. However, the Committee did not note the fact that such an investment by tax dodgers was mostly in economically and socially low priority or even undesirable lines of investment, while the need of the hour is to have a judicious investment which must be helpful to the economy.

However, the Government of India decided to introduce another voluntary disclosure scheme. The President promulgated an ordinance entitled 'Voluntary Disclosure of Income and Wealth Ordinance, 1975' on 8 October 1975 whereby the voluntary disclosure scheme was introduced. The ordinance enabled persons and firms with black *income* and *wealth* to take advantage of this scheme. Declarants were given three months (till the end of 31 December 1975) to declare their unaccounted income and wealth. The ordinance provided that all black income would be clubbed together irrespective of the years over which this was earned and treated as a block separately from other taxable income for the purposes of income tax liability. Though two years earlier, the highest income tax rate had been reduced from 97.75% to 77% to reduce the temptation for income tax evasion, the ordinance provided for a still further concessional rate of tax on income disclosed under this Scheme. The income tax, on a slab rate basis, varied from 25% to 60% on the disclosed income. The declarant was to invest 5% of his disclosed income and 2.5% of the disclosed wealth in notified government securities. The proceeds of such securities were earmarked for projects of high social priority like slum clearance and low income housing. The declarants were granted immunity from reassessment of income disclosed under this scheme. The income disclosed was not to be added to the wealth of the declarant for determining his wealth tax liability. To put differently, once a declarant had paid his income tax on the disclosed income, he was in no way to be taxed further on the same disclosed income. It would not be treated as part of the wealth of the declarant for the period it was retained by him. Any assessee who had been

sent a notice under Sections 148 or 139 of the Income Tax Act or under Sections 14 or 17 of the wealth Tax Act was not allowed to avail of the opportunity. Similarly, no person could file his regular income tax return during this period, hide a portion of his income and then declare it at a later date to take advantage of the concessional tax rates. Hidden income was to be disclosed prior to the filing of any income tax return once the scheme came into operation. Further, the scheme protected the declarants from any kind of penalties for their illegal concealment of income and/or wealth in the past.

In the case of persons whose premises had been raided by the income tax department and cash, assets or documents had been seized, the voluntary disclosure scheme was applicable in a modified form. These persons were not entitled to the special concessional rates of tax for income earned before such raids, and on such income they were to pay tax at the normal rates applicable to the years in which it was earned. However, they could avail of the special rate in respect of black income earned after the income tax raids. The benefits of the scheme were not available to smugglers and foreign exchange racketeers in respect of whom detention orders had been issued under the Conservation of Foreign Exchange and Prevention of Smuggling Act.

The new voluntary disclosure scheme differed from the earlier ones in four essential ways.

Firstly, the earlier schemes did not cover concealed wealth while the new one did.

Secondly, the earlier schemes had permitted income already detected by the authorities to be included in the voluntary disclosures. The current scheme did not allow this.

Thirdly, the 1965 scheme had allowed a period of six months for the date of final tax payment. The current scheme, though expecting the payment of income tax at the time of making the declaration, allowed fifteen months after the final date of declarations.

Fourthly, the new scheme provided for separate voluntary disclosure of the black income and wealth.

Fears were expressed that this scheme, like its predecessors would not result in any substantial disclosures. Even the official circles were not placing the expected disclosures beyond Rs 1 000 crores at the most. As it happened, however, this scheme turned out to be a far bigger success and beyond all these expectations. In the beginning the disclosures were very few. The Ordinance of 8 October 1975 had been silent about a number of possible legal repercussions for the declarants. But the authorities launched a campaign to clarify various questions involved and provided additional immunity against the

application of certain other laws. On account of these various clarifications, exhortations, modifications and additional incentives, the disclosures picked up as the closing date of the scheme approached nearer.

The total disclosures of income and wealth under this scheme turned out to be more than Rs 1500 crores leading to an income tax realisation of over Rs 250 crores and a corresponding investment of about Rs 40 crores in government approved securities.

There were some important factors which led to the success of this scheme beyond all expectations.

Firstly, the rates at which the income tax liability was to be determined were quite low compared with even the normal tax rates.

Secondly, additional concessions included the exemption from wealth tax on the same income to which an income earner is normally subjected to if he puts his income into specific forms of taxable wealth.

Thirdly, it is stated that the additional assurances with regard to not insisting on the disclosure of the source of income, and also the permission to disclose the acquisition of income and wealth with respect to any previous date of acquisition enabled the declarants to avoid the liability substantially.

Fourthly, various immunities were provided from the provisions of various sister Acts against economic offences.

Fifthly, the risks associated with continuous concealment of income and wealth were increasing. Income tax raids, tightening up of various penal actions and a mounting pressure on black money had a frightening effect on the tax dodgers. And in the face of these threats the tax evaders were given a chance to declare their concealments and return to the mainstream of economic life.

An Assessment

One thing is quite clear and that is that the parallel economy created by the circulation of black money accounts for a substantial part of our economy. The Wanchoo Committee had estimated that the money value of the deals made with black money amounted to Rs 7,000 crores for the year 1968-69 and yielded a black money income of Rs 1,400 crores. One can well imagine the staggering amount to which the black money must have accumulated over all these years. Actually, the process of black income generation, it is felt, got further accelerated in the wake of the Indo-Pak War of 1971, the increasing controls and regulations on the working of the market mechanism and the inflationary pressures and rising prices. In the

Wanchoo Committee Report, Dr D.K. Rangnekar had appended a minute of dissent[13] and pointed out that in his judgement the annual generation of black income was about twice the amount estimated in the main Report of the Committee.

Thus irrespective, of what proportion of black money was actually declared under this Scheme, one may safely say that it was still a small proportion of the total hidden amount. It only enabled the tax dodgers to come clean in so far as their past misdeeds were concerned. In itself, it did not and could not provide for plugging the loopholes in the working of the economy and the legal structure through which the black money gets generated. The scheme recognized this fact when it permitted the tax evaders to voluntarily declare any black incomes earned even after the income tax raids. This implies, therefore, that the scourge of black money cannot be eradicated by a system of voluntary disclosure unless the very fountain-head of this evil is uprooted. The vary working of our economic system must be restructured so as to eliminate the possibility of generating black income. A large number of possible assessees are still out of the tax net and must be roped in.

Again, the scheme was not able to (and could not be expected to) touch the problem of tax evasion through consumption. The probability of a person getting caught is more if he conceals his income from the tax authorities by putting it in some form of taxable assets. But if he consumes it away, he is less likely to be caught. Under the recent scheme a person who had frittered away a portion of his earnings on extra consumption need not disclose that part. This gap in the last scheme points towards the need for plugging the loopholes in our tax laws

Moreover, the 1975 scheme, though in itself a success, is accused of an element of *inequity* as between the honest tax-payers and the dishonest tax dodgers. The introduction of such a scheme may be justified on several grounds, but looked at from the point of view of the honest tax-payer, it amounted to gross injustice. The tax dodger, over the years, must have earned far larger amounts on his concealed income and wealth and now he was being asked to pay only a small tax on the same. His tax liability was being determined at rates which were lower than even the normal rates. Instead of punishing the tax dodger, the voluntary disclosure scheme was treating him on favourable terms. Moreover, he was also getting a number of additional concessions on wealth tax, and immunity from many other economic

[13] *Ibid*, pp. 249-51.

offences. Further, since no questions were to be asked as to source of the disclosed black money, the tax evader could further bring down his tax liability by splitting the total amount of black money among members of his family, and so on. An honest tax-payer is not given a chance to have any of these advantages, especially if he is a salary-earner.

THE INDIRECT TAXATION ENQUIRY COMMITTEE (JHA COMMITTEE) REPORT

An underdeveloped country like India needs a healthy and efficient system of indirect taxation which should be able to meet various revenue objectives of the government and at the same time should have an invigorating effect upon the economy. It should conform to the national objectives and overall social and economic policies. With changing circumstances, a review of the existing tax system often becomes necessary. The last enquiry covering a wide review of indirect taxation in India had been undertaken by the Taxation Enquiry Commission headed by Dr John Mathai in 1950's. Of late ,however, there was an expression of increasing dissatisfaction with our indirect tax system. Accordingly, in July 1976, the Government of India appointed the *Indirect Taxation Enquiry Committee* under the chairmanship of *L.K. Jha*, Governor of Jammu and Kashmir. This Committee had very wide terms of reference which included the following:

A review of the existing structure of indirect taxes of the Centre, States and Local Bodies;

An examination of the role of indirect taxation in promoting economic use of scarce resources;

An examination of the structure and level of excise duties, the impact of these duties on prices, their incidence on various expenditure groups and their cumulative effects, and the scope for widening the tax base and increasing the elasticity of the system;

An examination of the feasibility of value-added-tax (VAT) system and, if found feasible, suggesting the way it should be applied;

An examination of the question of assisting particular industries or sectors by granting tax concessions, keeping in view the administrative and revenue aspects, etc;

An examination of the structure of import duties from the point of view of import trade controls, protection etc.

The Committee was also asked to consider the question of proper balance between indirect and direct taxes in the tax structure while using indirect taxes for mobilising resources, and also to suggest any

Constitutional changes which might be necessary for implementing its recommendations, the needed changes in the administrative set up in the government machinary and other related problems.

The Committee submitted its final report in October 1977.

The Committee pointed out that the share of indirect taxes in India had been increasing steadily and that this percentage share was far greater than the corresponding share in either developed or under-developed countries. But it maintained that it is not possible to lay down on *a priori* grounds any optimum proportion between indirect and direct taxes. "How heavy the burden of taxation should be, calls for a judgement—which is partly political—about the sacrifice which the people could be called upon to make and, partly economic—based on considerations relating to savings, consumption and capital formation, as well as the relative roles of private and public investment in the country's economic development. This judgement can only be exercised by Government." (Para 1.5.)

Criteria for Sound System of Indirect Taxation. However, even though exact proportion between direct and indirect taxes cannot be stated on *a priori* grounds, the Committee pointed out the prime criteria which should determine the soundness of an indirect tax system. *The first* is the adequacy of revenues which implies an adequate measure of built-in-elasticity with reference to national income. *The second* criterion is that the taxes should be progressive in their incidence. *Thirdly*, since indirect taxes greatly influence the working of the economy through effects on investment, production, employment, resource allocation, shifts in relative costs and prices etc., it follows that these taxes should not militate against the chosen national objectives. *Fourthly*, these taxes should satisfy the usual canons, that is, they should be simple, certain, economical to collect, and should cause minimum harassment to tax-payers.

Evaluation of the Existing System. While examining the system of indirect taxes, the Committee studied their incidence on various expenditure groups as stated in their terms of reference. Earlier, the Department of Economic Affairs, Ministry of Finance, had conducted such a study in 1968-69 which related to the year 1963-64. That and earlier studies had been based upon NSS data. The Committee commissioned the National Institute of Public Finance and Policy to undertake a fresh study on its behalf on the basis of NSS data 1973-74. This study (*see* Table 21.2) shows that indirect taxes are quite progressive and further that the incidence is more on expenditure groups in urban areas than on those in the rural areas.

But the Committee found that the existing system of indirect taxes

TABLE 21.2

INDIRECT TAXES AS PER CENT OF TOTAL EXPENDITURE AND TOTAL CASH EXPENDITURE BY PER CAPITA EXPENDITURE GROUPS (1973-74)

Monthly per capita expenditure (Rs)	*Rural* Tax as % of total expenditure	*Rural* Tax as % of total cash expenditure	*Urban* Tax as % of total expenditure	*Urban* Tax as % of total cash expenditure	*All India* Tax as % of total expenditure	*All India* Tax as % of total cash expenditure
0—15	2.91	4.55	3.63	4.44	2.96	4.56
15—28	3.33	5.25	6.31	6.79	3.63	5.46
28—43	4.45	7.25	7.36	7.93	4.89	7.41
43—55	6.18	10.32	9.66	10.31	6.85	10.31
55—75	6.71	11.40	11.86	12.70	7.92	11.82
75—100	10.02	16.43	14.80	15.85	11.40	16.21
100 and above	16.17	22.46	30.19	31.35	21.96	26.77
All Households	8.03	12.87	17.96	19.03	10.54	14.96

Source: Report of the Indirect Taxation Enquiry Committee.

had developed on a haphazard basis without any set policy guidelines. For example, while discussing the phases through which the Central excise duties have passed, the Committee observed that "There was no clear cut shift in the policy regarding the pattern of taxation from one phase to the next. It was only a superimposition without any attempt to make appropriate adjustment in taxes imposed earlier." (Para 5.2.) The system of indirect taxation that we have today is the result of a more or less uncoordinated growth of major individual indirect taxes levied independently by the Centre and State Governments and Local Authorities. The structure of each of the major individual indirect taxes is itself not entirely rational or internally consistent, and their interaction often serves to enhance their harmful effects (Para 3.3).

The Committee noted the lack of uniformity and abundance of diversity regarding rates, coverage, procedures etc., in indirect taxation, especially in the sphere of State taxes like sales taxes, octroi and the like.

The Committee found that the existing indirect taxation does not have an adequate built-in-elasticity because each year the tax rates

have to be revised upwards and coverage increased to meet revenue requirements.

But the biggest weakness or defect of indirect taxes in India was found to be their cost-cascading effects. In India taxes are imposed either on per unit basis, or on *ad valorem* basis. In the latter case, the tax is a certain proportion of the *total value* of the taxed object. In both cases, therefore, the cost of acquisition by the producers at the next stage goes up to which they add their own proportionate profit margin. The cascading or snowballing effect is still more in the case of *ad valorem* taxes. "When taxes fall on inputs and on the final product, such of these taxes as are levied on an *ad valorem* basis fall not only on the value of the products, but at each stage they fall on the taxes that may have been earlier levied on them. Alongside, there is an escalation of costs and profits at each stage. " (Para 3.7.) The snowballing, in turn, brings in many undesirable effects. *Firstly*, "With widespread taxation of inputs by more than one authority, it is not possible to control the incidence on final products" (Para 3.9.) As a result it becomes very difficult to have an assured progressive tax policy. *Secondly*, taxation of inputs promotes vertical integration to avoid taxation since captive consumption does not bring in tax liability due to absence of sales transactions. *Thirdly*, the use of indirect taxation as a policy tool becomes less effective. *Fourthly*, the general escalation of costs hinders exports. It is not easy to refund the tax collected on all inputs for encouraging exports; and in any case sales tax is not refunded. It is both more practical and internationally acceptable to refund value-added tax.

Another important defect of our indirect tax system is in multiplicity of rates, specifications, procedural comp ications etc. which make our taxes complicated, uncertain, discriminatory and administratively difficult.

The Committee argued that import duties have similar cost-cascading effects to the extent they are imposed on inputs, like raw materials and machinery and equipment. It pointed out that higher rates by themselves did not mean more revenue if there are quotas and other restrictions, etc. Therefore, there was a case to reduce duties on certain consumer necessities and professional items but not on luxuries.

Suggestions and Recommendations. The Committee dealt elaborately with the task of reforming the existing indirect taxes. It proceeded on the assumption that "the proposed changes should ensure an adequate and rising flow of resources of the Government and pave

the way for an integrated indirect tax system in the country which should be more efficient, more equitable and better oriented to further the objective of planned development." (Para 1.6.) Accordingly, the Committee tried to work out a system which avoided the main weaknesses of the existing set up. An important consideration before the Committee was to eliminate the snowballing effect of our indirect taxes which caused all kinds of distortions in resource allocation and made our economy a high-cost one.

The recommendations of the Committee were in the nature of both short-term and long-term measures, though they necessarily overlapped in certain areas.

In the field of *excise duties,* the Committee pointed out that specific duties tend to be regressive. An *ad valorem* duty encourages the production of lower cost goods while a specific duty encourages the production of expensive ones. The Committee maintained that *ad valorem* duties are more difficult to administer, but this problem can be overcome. Moreover, *ad valorem* duties have income elasticity and their rates don't have to be revised too often. It therefore recommended that like items should be taxed at same rates and there should be different slabs of excise duties with a general average of 20 per cent while a range of items should be kept free for economic and social reasons. Accordingly the Committee recommended *the abolition of taxation of inputs* straightaway. Further, the aim of modification in excise duties should be to ensure that cumulative effects on items like plant and machinery are avoided. Hence, the Committee recommended a reduction of duties on diesel engines, power driven pumps, electric motors, and refrigerating and air-conditioning machinery used for industrial purposes. It also recommended lowering of duty on cement. Some of these recommendations were accepted by the Government and put in the budget for 1978-79.

The Committee noted that there was a variety of criteria for granting of concession to small producers including the value or quantity of clearance, the number of workers employed, the use of power and the value of plant and machinery installed. It wanted to institute a uniform or at least a similar yardstick on a slab basis with reference to value of output. This recommendation was also accepted in the budget for 1978-79.

Regarding the simplification of procedure for collection and assessment of excise duties, the Committee noted the lack of popularity of the Central Excise (Self-Removal Procedure) Scheme and stressed the fact that the scheme provided against any possible loss of revenue, but not against the loss to the producer. Therefore, the

Committee suggested certain modifications in the Scheme to make it more practicable and acceptable.

In the field of customs duties, the Committee recommended that "from a purely economic point of view, lowering of import duties on raw materials would be desirable. The danger of a loss of revenue often gets exaggerated, because the prospects of higher revenues on account of larger imports as well increased excise revenues...are not taken into account. Of course, protection to domestic industry has to be ensured" (Para 7.14).

The Committee points out that same arguments apply to lowering of duties on capital goods also. The Committee did not find any rationale for having both the basic and auxiliary duties as separate levies on imports. But "countervailing duties, which are imposed on imports are equal to the excise duties levied on the like products produced indigenously, are fully justified on economic considerations." (Para 7.17.) These duties should not be abolished.

A strong plea had been made to the Committee for merging the *sales tax* with excise duties and earmarking the enhanced proceeds for the States. In the 1950's, the Taxation Enquiry Commission had also recommended that commodity taxation should be levied by only one authority, the Central Government. The Federation of Indian Chambers of Commerce and Industry also made a strong plea to that effect. Apart from uniformity in commodity taxation, various other advantages were also claimed for this step. But the State Governments pleaded against such a merger. They pointed out their unhappy experience in the field of additional excise duties in lieu of sales tax the revenues from which remained virtually frozen (though the Centre got more revenues from them by raising basic duties while keeping the additional duties unchanged). The State Governments also felt that by surrendering their rights to sales tax, their autonomy would be eroded and this would also undermine their financial discipline. The Committee saw weight in the arguments of the State Governments. It also noted that all commodities subject to sales tax were not subject to Central excise duties also. The States were collecting about Rs 500 crores by way of sales tax on those commodities which were free from excise duties. Moreover, excise duties are levied at the ex-factory price, while sales tax is levied at the final sale value. From this angle also revenue from sales tax should be more than the corresponding revenue from excise duties. Unfortunately, however, the sales tax has evolved into a burden upon both the producer and the consumer through raising costs. The Committee, after considering various aspects of the problem, recommended that: "On a balance of all the

considerations, we favour a single point tax at the last stage." (Para 8.16). Similarly, it recommended a reduction in the Central sales tax from 4% to 1% in stages. Exemption from registration for sales tax and keeping of accounts should be raised to Rs 2.5 lakhs. Sales of inputs to registered manufacturers should be free from taxation.

The Committee, like all earlier Committees, found octroi to be an obnoxious and harmful levy. It recommended its abolition—at least in stages, if it could not be abolished forthwith. The local bodies could be helped in finding alternative sources of funds or could be helped directly through grants. But the main emphasis of the Committee was on getting octroi abolished rather than on any particular alternatives to replace it.

Long-term Reforms. The above recommendations were not taking into account the need and possibility of long-term reforms of far-reaching importance. The Committee pointed out that it was not sufficient to limit the reforms to each individual tax. In order to mitigate the problem of cascading and to minimise the overlapping of excise and sales taxes, the Committee had suggested that on the one hand there should be a lowering of excise duties on raw materials and on the other, restrictions should be imposed on the power of State Governments to levy of sales taxes to the extent needed to ensure that there was no undue increase in cost of production and that each State essentially taxed its own residents. These restrictions should also ensure that the State policies did not work against national priorities. But all such reforms can be only a partial solution of the problem.

It is in this context that the Committee considered the case for VAT. As we know, VAT is a system in which tax liability is determined with reference to the net value added at each stage, so that the total tax liability on a good is in proportion to the final value of the product irrespective of the stages of production or trade that it passes through. The Committee had strong theoretical and other reasons for recommending the adoption of VAT. It however noted that administratively it is not an easy thing to adopt this ideal system. The Committee admitted that "It would be premature now to think in terms of a comprehensive system of VAT extending down to the retail level. But in order to put Central taxation on a rational basis, we would urge that serious consideration be given for moving over to a VAT system at the manufacturing level—the so called MANVAT. It is our view that in ultimate analysis a satisfactory solution to the various distortions and problems that arise from an

extended system of excise taxation lies in the adoption of MANVAT." (Para10.9.) "It would be prudent to make a start with 3 or 4 industries which produce final products. . . . Such a pilot project would enable Tax Administration to test out procedures and study the reaction of the tax-payers." (10.18.) Administratively MANVAT is not much difficult. Accounting problems would be the minimum while dealing with big manufacturers, and the number of tax-payers would be small. The Committee recommended that the tax credit version of MANVAT should be adopted. This version has many advantages such as the possible relief for certain goods, a relief on the basis of use of labour-intensive techniques, or the need to tax value added at stages before the manufacturing stage if it is not possible to apply MANVAT for some reasons. Rule 56-A of the excise tax system already provides a method similar to the tax credit one. Extension of this Rule was recommended as the first step towards adoption of MANVAT. At the same time, however, it was necessary that sales tax on inputs sold to manufacturers should be avoided.

It goes without saying that the Committee has made far reaching recommendations. By the very nature of the problem it was analyzing, it could not recommend an overhauling of the entire system without suggesting that experience along the new system should be gathered by the authorities. To this end, therefore, its recommendations fall into short-term and long-term proposals. Furthermore, it was facing a difficult issue in the form of merger of sales tax with Union excise duties. The solution involved the will and aspirations of the States, their past experience with the Centre and various economic and political questions. The Committee decided in favour of retention of sales tax by the States. However, it recommended a long-term switch towards VAT system right through indirect taxation at both the Central and State levels together with the abolition of octroi at the local level.

FEATURES AND ASSESSMENT OF THE INDIAN TAX SYSTEM

Tax system of a country is an integral part of the overall economic system of the country and is expected to contribute to the achievement of chosen social and economic objectives. An appropriate tax policy brings about the required tax system and manifests itself in the rate structure, tax deterrents and incentives and the like.

Indian tax system may broadly be divided into direct and indirect taxes for the purpose of noting their broad features. Direct taxation includes personal direct taxation and corporate taxation. In India,

the general approach is that direct taxation should be associated with income and wealth rather than consumption and expenditure. Accordingly, income tax forms an important segment of direct taxation in our country. Income tax is payable by both physical persons and juristic or legal entities including associations of persons, etc. The rates, exemptions and rebates are all determined for each year of assessment and are prescribed in the annual Finance Acts. However, non-agricultural income can be taxed only by States but all States do not levy this tax. A company, being a legal entity distinct and separate from individual share-holders comprising it, also pays income tax (called corporation tax). However, companies have been allowed various tax concessions for encouraging investment in general and in specific areas and industries in particular. These tax concessions have been varying quite frequently in coverage and rates causing a good deal of uncertainty. Other direct taxes include provisions for taxation of capital gains and gifts, an annual tax on wealth and estate duties. A tax on interest earnings of scheduled commercial banks was there for some time and was reintroduced in 1980. Similarly, a tax on personal consumption expenditure was there for two brief spells before it was finally abolished. Direct taxes of States and local bodies include taxation of agricultural incomes, land revenue, taxes on buildings etc.

Indirect taxes of the Central Government include taxation of capital transactions, taxation of advertisements, customs duties and excise duties. Indirect taxes of States and local bodies include sales tax, certain excise duties, entertainment tax, taxation of motor vehicles, registration and stamp duties etc.

Starting with the criterion of adequacy, we find that though in the earlier years, tax revenue did not increase fast enough, such is not the case now. The tax system has exhibited a good deal of buoyancy. Most of the budget estimates show that even with the unchanged rates and coverage of taxes, tax revenue was expected to rise at a rate faster than that of income. The tax system has also exhibited elasticity when we note that year after year the tax revenue has increased substantially through variations in coverage and rates of taxation. However, one may claim that in spite of these increases, tax revenue has not been able to yield enough resources for the Government and it has to resort repeatedly to market borrowings and deficit financing to meet its increasing requirements. A limited amount of market borrowings and deficit financing are justified on various grounds, but it is a general belief that in India, deficit financing often crossed its limits and caused an inflationary rise in prices. Thus we may conclude

that our tax system has a high productivity but not a high enough one Our tax policy has aimed at raising the tax revenue through upward revision of tax rates, wherever possible, and extending the coverage of the taxes. Since the scope for revision of rates and coverage was limited in direct taxes, our tax policy has concentrated upon tapping indirect taxes to a disproportionate extent. This has made our tax system inequitable and regressive. At the same time, even the direct taxes have been suffering from inequity partly due to the non-taxing of agricultural incomes and partly on account of tax evasion. If adequate steps had been taken to plug the loopholes leading to tax evasion the need to spread the indirect tax net would have been reduced. As it is, because of the large scale tax evasion (both in the direct and indirect taxes), the proportionate burden upon those who are paying the taxes has increased very much.

Our tax system falls short of the criterion of efficiency. In most cases it is not within the limits of practicability. On account of complicated laws and rapid changes in their provisions, our tax system has lost the qualities of simplicity and certainty. Tax liabilities are subject to a variety of interpretations and this opens up a scope for tax evasion and avoidance also. Kaldor had claimed that our tax laws suffer from defective definitions of some basic concepts and our legal system allows certain loopholes for tax evasion. For example, our laws permit holdings of benami properties. Coupled with shortfalls in the administrative machinery, our country faces an endemic problem of tax evasion and black money. Complexity of our tax system works against its efficiency. It must be remembered that there are also certain inherent tendencies contributing to the growing complexity of our tax laws. There is the primary question of mobilisation of resources. It is found that there is a need to increase the tax coverage for this purpose and that, by its very nature, militates against simplicity of taxation. Furthermore, taxation is widening its role as an instrument of social and economic justice, resource re-allocation, and reduction in regional imbalances. In a modern economy tax provisions cannot be simple enough for the obvious reason that a very large number of taxes have to be imposed and they must also conform to the realities and complexities of economic life of the community. But our tax system, it appears, tries to accomplish too much by way of using tax provisions It proceeds on the premises that the economy in its diverse aspects readily responds to various tax stimuli and deterrents. In the process of providing a tax incentive or a tax deterrent for several economic and other objectives, we have ended with a very complicated system of tax laws. This defect of

our tax system has been noted frequently enough and the complexities and ambiguities are found both in direct and indirect taxes. Accordingly, our policy should now be to simplify our tax laws to the extent possible and at the same time make them more effective and responsive to the needs of the economy and the society. Requisite administrative and procedural reforms are also needed to achieve this objective.

In this context, in certain quarters, there has been a move that direct taxes in India should be consolidated into one. Direct Tax Law Committee (initially headed by Shri A.N. Palkhiwala and later by Shri S.C. Choksi) was specifically asked to consider and recommend on "the advisability of consolidating the laws relating to income tax, sur tax, wealth tax and gift tax into one Act or in any event providing a consolidated return for these taxes." The case for consolidation of direct taxes into one rests, amongst other things, on the fact that the bases of these various taxes are interdependent and therefore a single consolidated tax would be economical and would provide lesser scope for tax evasion. Moreover, this would speed up the process of assessment, collection and recovery of taxes due and would be administratively more practicable.

However, we should distinguish between the consolidation of direct taxes into one on the one hand and the need to have a single comprehensive tax return on the other. It should be remembered that these different taxes are designed to serve a variety of objectives which no single tax would be able to. The benefits of the speedy assessment, collection and recovery and plugging of tax evasion etc., can be had by instituting a single comprehensive return as suggested by Kaldor. There is a need, however, to simplify a number of tax provisions and make them more effective. Currently, the tax rates are subject to annual changes through the annual Finance Acts. This causes a lot of uncertainty and often leads to anomalous situations. The Choksi Committee, after studying laws and procedures of direct taxes in Britain, USA and Japan, has recommended that there should be a consolidated legislation to be called "The Direct Taxes Management and Administration Act" for all the four direct tax laws (income, wealth, gift and sur tax). It has also recommended a common assessment procedure, a common appellate procedure, a common procedure for recovery of taxes and the establishment of a Central Tax Court with all-India jurisdiction to deal exclusively with litigation under direct tax laws.

Similarly, the Indirect Taxation Enquiry Committee (Jha Committee) has made several recommendations regarding indirect taxation

which we have discussed elsewhere.

It is commonly felt that our tax system is not sufficiently equitable as between different sectors of the economy on the one hand and between individual members of the society on the other. It is a common knowledge that agricultural sector of our country is taxed quite lightly compared with the non-agricultural ones. Partial integration of agricultural income with non-agricultural income for the purpose of assessing non-agricultural income is only an incomplete step in the direction of removing this inequity. Actually, this contributes to inequity as between individuals. The need for a rational and heavier tax on agriculture has been argued in the chapter on agricultural taxation in this book. We find, however, that the reforms like the introduction of AHT as recommended by the Raj Committee are not being given sufficient attention by the States. In certain cases, even land revenue has been reduced or abolished since the Raj Committee reported. There have been instances of liberalisation of even the taxation of agricultural income. The States are actually subsidizing agricultural inputs like water for irrigation by supplying them at prices below cost. Even the Central Government policy has been to subsidize agricultural inputs or to tax them at concessional rates. Such an approach not only causes an inter-sectoral imbalance in tax burdens, it also contributes to income inequalities within the agricultural sector as the agricultural inputs under consideration are mainly used by the richer farmers only.

Inequity of tax burden as between individual members of society results from a difference between legal progression and effective progression.[14] On paper, our direct tax laws are highly progressive. Actually, a complete tax compliance would generate a forceful disincentive to work and earn more. The provisions of the direct tax laws are all designed to reduce income and wealth inequalities. Reality, however, is quite different. There is a general paucity of data and accounts and our tax administration is not able to cope with this situation. Various conceptual and legal deficiencies also contribute to this state of affairs. Thus, for example, we have a problem in separating business expenses from personal consumption ones. It is equally difficult to distinguish between essential and non-essential business expenses. The resultant large scale tax evasion not only causes a loss of revenue to the exchequer, it also distorts the consumption pattern in the economy and diverts its productive resources to a waste-

[14]Gian Singh Sahota, "Income Distribution and Taxation," *Economic Times* Annual Number, 1974.

ful use.

The system of indirect taxation in India also contributes to inequalities. Here also in terms of rates and coverage, the system is highly progressive. While necessities are exempt from taxation or are being taxed at quite low rates, luxuries are subjected to higher rates. But the evil of large scale tax evasion is equally prevalent in this case as well. Rather in certain cases we find that while indirect taxes are collected from consumers by way of excise duties or sales tax, the same is evaded and misappropriated by the producer or seller. Similarly, it should be noted that taxation of inputs and intermediate goods is itself regressive. This is because such taxes have a cost-cascading effect. In an economy of shortage like ours, this enables the manufacturers and sellers to mark up prices by margins far in excess of the taxes imposed. Moreover, the system breeds a process of taxation of taxes and this pushes up costs and prices still further. And inflation, as we know, contributes to inequalities.

The system of direct taxation in our country is loaded in favour of capital intensive techniques. The tax concessions like tax holidays, initial investment allowance and so on are all related to the investment of capital rather than to employment of labour. The only concessions favouring the labour employment are like initial allowance on houses built by the employers for lower-income employees. Repeated budgets of the Central Government have ignored the employment aspects of the budgetary proposals. Incidentally, this factor also contributes to income and wealth inequalities.

Our tax provisions are expected to be of help to the economy in achieving a quicker rate of capital accumulation and economic growth. But they are concerned more with provisions for investment and less with those to encourage savings.The incentives provided to attract people towards savings are limited and their inadequacy increases in view of rising prices and falling purchasing power of money. However for this purpose our direct taxes are studded with a large number of exemptions, rebates and the like for encouraging savings, and channelling of investment into particular lines. Priority industries get a more favourable treatment. Income from particular investments are exempted from income taxation up to a certain extent. To the extent these incentives go, they are good. But we find that in some cases there are too many provisions relating to these objectives and the tax laws have lost simplicity and probably even effectiveness. Instead they tend to provide certain loopholes to the tax dodgers. Some provisions are even contradictory. It is also suggested that in corporate taxation the approach to choose profits as the tax base

should be replaced by expenditure. In our economy where capital and other resources are in short supply, profit as the tax base encourages wasteful and uneconomic expenditure to reduce the accounting profits. However, as stated earlier, it may not be expedient enough to shift the tax base from profit to expenditure, but the existing tax laws certainly need a good deal of simplification. The intelligence and reporting system must be made more comprehensive and effective without bringing in any undue harassment of the honest tax-payers. All told, our tax policy seems to have failed in curbing consumption and diverting savings into selected lines of investment. The rate of growth of the economy also has not been fast enough.

22 RAILWAY FINANCES

The railways are the principal departmentally-run commercial undertaking of the Government of India. The financial relationship between the railways and the Central Government is governed by the recommendations made from time to time by the Railway Convention Committee of the Parliament. The Budget of the Railways and the Demand for Grants relating to railway expenditure are presented to Parliament separately in advance of the main budget of the Central Government. However, the total of receipts and expenditure of the railways are incorporated in the Budget Statement of the Government of India.

The importance of railways in our national economy cannot be over-estimated. Railways are the biggest public enterprise of the Government of India in terms of investment and employment (both direct and indirect). They play an indispensable role in our economy both as carriers of goods and passengers and as an active influence and element in the cost of most goods and services. If we look at the investment figures only, we find that the capital-at-charge has increased rapidly during the Plan period. Thus while the average capital-at-charge during the First Plan was Rs 889.47 crores, it rose to Rs 1,320.78 crores and Rs 2,170.97 crores during the Second and Third Plans respectively. During the Annual Plans of 1966-67 to 1968-69, the figure averaged Rs 2,973.62 crores rising to Rs 3,535.20 crores and Rs 4,447.79 crores during the Fourth Plan and Fifth Plan respectively. In 1980-81 (BE) the figure stood at Rs 5756.32 crores.[1] Similarly, the gross tariff receipts from railways for 1979-80 (BE) were estimated at Rs 2545.35 crores out of which earnings from goods traffic were Rs 1587.30 crores. Total assets of the railways, as at end-March 1979 stood at Rs 5953.43 crores and they contributed to the Central Revenues by way of dividend (interest and contribution) on capital-at-charge Rs 295.97 crores and Rs 319.67 crores in 1979-80 (RE) and 1980-81 (BE) respectively.

Railway finances were separated from the Budget of the Government of India on the recommendation of the Railway Convention of 1924. Keeping the railway finances as a part of the main budget

[1]Explanatory Memorandum on the Railway Budget, 1980-81, p. 53.

was found to cause a great deal of uncertainty to the main budget and was a source of handicap to the railways The main budget was a victim of the commercial fortunes of the railways while the railways found that they could not build up adequate development and reserve funds and have long-term plans because profits of good times could not be used to wipe out losses of hard times. Therefore, the Convention of 1924 proceeded along the idea that while the Government should be assured of a regular contribution by the railways, the railways should be able to plan their own development and other programmes on a long-term basis and there should be a sufficient incentive for them to improve their finances. Accordingly, the Convention provided that the railways should provide interest on capital-at-charge and in addition should also contribute to the general revenues a sum equal to 1% of the capital. If any surplus was left after meeting these obligations, then 1/5th of such a surplus should also go to the general revenues. And further, in case this surplus exceeded three crores of rupees, then an additional 1/3rd of this surplus was also to be contributed to the general revenues. However, not all lines were commercially viable and many strategic lines were bound to yield losses. Such losses were to be deducted from the contributions payable to the general revenues by the railways. The commercial nature of the railways made it likely that in some years they would not be able to meet even their fixed contributions to the general revenues. It was, therefore, stipulated that any such backlog would be made good from surpluses in subsequent years.

The Convention of 1924 thus gave a much greater freedom to the railways. They could retain a portion of the surplus after meeting fixed changes to the general revenues, and this was an incentive for them to adopt appropriate measures for increasing efficiency. During the period 1924 to 1930 (for which the Convention worked admirably) railways were able to contribute Rs 36 crores to the general revenues and credit Rs 19 crores to the Reserve Fund.

The Great Depression of 1930's dislocated the well-set pattern as established by the 1924 Convention The earnings of railways declined to a very low level and they were not able to meet even interest charges out of their earnings with the result that the Reserve Fund was exhausted by March 193? and for the subsequent period up to 1935-36, the railways could not make any contribution to the general revenues. Instead they had to make withdrawals even from the Depreciation Fund to the extent of Rs 31.50 crores. From 1936-37 onwards, railway finances started recovering, though quite slowly, and some

modest surpluses were recorded. However, technically, the railways could make a contribution to the general revenues only after paying back their withdrawals from the Depreciation Fund. The authorities, however wanted that the railways should make contributions to the general revenues. The Finance Member, therefore, announced a moratorium on liabilities of the railway finances to the Depreciation Fund for three years. By such a step the general revenues gained modestly but the railways remained financially as weak as ever.

Thus, though the Plan as put forth by the Convention of 1924 was intrinsically sound, in practice it did not work well on account of the depression of the 1930's and the attitude of the authorities for preferring the contributions to the general revenues at the cost of financial health of the railways. During this very period, the railways were also facing an intense competition from the road transportation. These combined factors led to the total exhaustion of the Reserve Fund and heavy withdrawals even from the Depreciation Fund. It was only the onset of the Second World War which finally enabled the railways to overcome their financial difficulties. The general stimulus of economic activity increased the earnings of the railways and they were able to pay back their loans from the Depreciation Fund by 1942-43 as also meet the payment of arrears to the general revenues which had accumulated to Rs 35.41 crores by the end of 1938-39.

But it has to be kept in mind that even war-condition earnings did not help the railways adequately. With improving railway finances, the Government wanted to benefit itself especially on account of its war needs. It felt entitled to this benefit all the more because a large part of the railway earnings were from the Governmental and defence activities and railways had curtailed their services to the general economy. In order to drain away the earnings of railways to the general revenues, the Central Assembly passed a resolution stating that the surplus on commercial lines (minus the loss on strategic lines) was to be divided between the general revenues and the railway reserves in the ratio of 3 to 1. For the subsequent years the division of the surplus was to be decided on a yearly basis keeping in view the relative needs of the general revenues and the railways, till a new convention was adopted. The resolution, in a way, ensured that the railways would be made to contribute a maximum possible amount to the general revenues without regard to the strengthening of their own finances especially against the possible onslaught of lean years. The railways lost the golden chance of building up large Depreciation and Reserve Funds out of their war-time earnings. Instead the war

activities led to a great strain on the physical resources of the railways. There was a heavy depreciation of the rolling stock due to an excessive use. A large scale postponement of the necessary replacement of railway equipment and rolling stock took place. During the 1930's the railways had not been able to go ahead with full renewals and replacements and the deficiency could not be made up during the war also. Rather due to the war-time demands and scarcities, the railways found it difficult to meet their own needs of repairs and raw materials. Actually about 4,000 miles of track and 4 million sleepers were supplied by the railways to the Middle East in addition to more than 8% of the metre gauge of Indian railways. This led to even a dismantling of 26 branch lines. All told, the railways emerged, after the war, in a very tattered condition and in need of immediate overhaul and repairs. Financially, also, the railways contributed Rs 158 crores to the general revenues during the war years.

It was realized that due to rising prices, the system of providing for depreciation was not a realistic one because the transfers to Depreciation Fund were based on the acquisition and not on replacement costs. This made the Depreciation Fund inherently insufficient for the needs of the railways. Accordingly, in 1944-45, a new arrangement was arrived at according to which a major portion of the capital expendiiture of railways was charged to revenue. At the same time, during 1944-45 to 1946-47 an additional sum of Rs 4 crores was credited to the Depreciation Fund together with a withdrawal of Rs 11.76 crores from the Reserve Fund. However, in view of the excessive wear and tear during the war days, this much allocation was by no means sufficient to meet the requirements of the railways. The contribution to the general revenues was however placed at a figure of Rs 32 crores p.a. for 1944-45 and 1945-46. And in 1946-47, the railway contribution was set at 1% of the capital-at-charge on commercial lines minus loss on strategic lines. Of the balance of the surplus, if any, Rs 3 crores were provided for Betterment Fund and 50% of the balance was to go to the general revenues. The Betterment Fund was meant to provide passenger facilities.

The partition of the country was the next set-back for railways and in 1947-48, the railways ended up with a deficit after paying interest on capital-at-charge. But the demands of the general revenues on railways continued with the result that in 1948-49, out of a surplus of Rs 22 crores, the general revenues got Rs 7 crores, Rs 1 crore went to Betterment Fund and Rs 12 crores were credited to the Depreciation Fund.

By now, however, thinking was on foot to organize the railways

and their finances on a more sound footing. A number of railway lines owned by Princely States were taken over by the Government on 1 August 1949 (namely those of Baria, Palanpur, Rajpipla, Cambay, Kolhapur and Sangli) The railway lines owned by the remaining Princely States were taken over in 1950. Only a few light railways remained in private hands. The railway administration was thoroughly overhauled by organisng it into six zones. Later on, it was found that due to operational reasons, some of the zones were too unwieldy and as a result the number of zones was increased to seven with effect from 1 August 1955 and later to nine zones. namely, Northern Railway, North-Eastern Railway. North-East Frontier Railway. Fastern Railway, Central Railway, Western Railway, SouthernR ailway, South-Eastern Railway and South-Central Railway. Each zone is put under charge of a general manager.

At the same time, a new Convention was adopted for a period of five years from 1950-51 to 1954-55 with the following main provisions. The railways were to make a contribution to the general revenues at the rate of 4.0%on the capital invested out the general revenues (excluding the capital invested in lines running at a loss). The Development Fund was to be given as pecial attention. Since Partition, only Rs 2.18 crores had been credited to it. During the next three years. viz; 1950-51, 1951-52, and 1952-53, it received Rs 10.52 crores, Rs 10.65 crores and Rs 12.76 crores respectively. The contributions to the Development Fund, however, again declined to just Rs 3.29 crores and Rs 9.70 crores in the next two years. For the Depreciation Fund a minimum of Rs 15 crores p. a was fixed. This Fund, however, received Rs 33.59 crores in 1950-51 and Rs 30 crores each for the years 1951-52 to 1954-55.

This arrangement could at the most be considered an *ad hoc* one. It was to be revised in five years. Though the tax-payer had been granted the status of a shareholder, the rights and obligations of the Government were a mixture of different positions which could be assigned to the Government. However, a significant feature of this arrangement was that the railways could be expected to concentrate more on their development programmes, especially since the Depreciation Reserve Fund had got a priority over the Revenue Reserve Fund.

The 1954 convention stipulated only a limited number of changes. The Depreciation Reserve Fund was to get Rs 45 crores p.a. in view of increased needs of the railways. The Development Fund was now supposed to cover the housing of Class III employees also. The cost of unremunerative new lines costing more than Rs 3 lakhs was also

charged to the Development Fund At the same time, the basis of calculating the 4% dividend to be paid to the general revenues was slightly modified. This Convention remained in force till the end of 1960-61. In actual practice, however, it was found that the Development Fund did not receive as much attention as it deserved. Only Rs 7.57 crores were credited to it in 1955-56 and Rs 20.56 crores in 1956-57. The figure fell to Rs 13.63 crores and Rs 18.92 crores in the next two years and rose to Rs 34.47 crores and Rs 35.09 crores in the subsequent two years. The closing balance stood at only Rs 19.13 crores in 1960-61 as against Rs 17.54 crores in 1954-55. The Revenue Reserve Fund which had a closing balance of Rs 38.36 crores at the end of 1954-55 stood at Rs 53.44 crores at the end of 1960-61. The inadequacy of the Depreciation Fund was obvious in spite of the extra amounts credited to it. As a result, its closing balance fell from Rs 100.69 crores at the end of 1954-55 to only Rs 19.79 crores in 1960-61. To look at the picture from another angle, while capital-at-charge of railways increased from Rs 850 crores in 1951-52 to Rs 1521 crores in 1960-61, the net revenue increased from Rs 61.75 crores to Rs 87.87 crores only.

In the next Convention it was adopted that the railways should contribute 4.25% instead of 4% of the capital-at-charge to the general revenues. The contributions to the Depreciation Reserve Fund were raised to Rs 70 crores p.a. for the years 1961-66. The actual contribution to the Depreciation Reserve Fund, however, amounted to Rs 380 crores for this period.

The Railway Convention Committee of 1965 recommended that the railways should pay a dividend of 4.5% on capital invested up to 31 March 1964 and for the capital invested after this date, the dividend should be at the rate of 6%. The tax on railway passenger fares was merged with the basic fares with effect from 1 April 1961 and the special payment in lieu of tax on passenger fares was merged with the dividend to general revenues. Out of the special payment, Rs 16.25 crores are being given to the States as a grant in lieu of the said tax and the balance is utilized to assist the States to finance safety works such as manned level crossings, overbridges and under-bridges. The Committee recommended a concession in the matter of dividend payment on certain element of capital like the capital invested in new lines and capital-at-charge of the non-strategic portion of the North-East Frontier Railway, the unremunerative branch lines and also the element of over-capitalization. In respect of the new lines, the dividend for the initial period of five years after the opening of the lines for traffic became payable from the sixth

year onward only if the net incomes of the new lines yielded a surplus after payment of the current dividend. Furthermore, if any liability for deferred dividend was not liquidated within a period of 20 years from the opening of new lines, then such liability was to lapse and the entire loss in the operation of the strategic lines was to be borne by the general revenues. The Railway Convention Committee of 1971 not only continued the above arrangements but extended additional concessions and exemptions to the railways. The Convention exempted the capital expenditure on strategic lines from the payment of dividend. The loss in the working of such lines was debited to the general revenues and if these lines yielded a surplus then also transfer to the general revenues was nót to exceed the level of the normal dividend. It was also decided to amortise the unproductive capital to the extent of the interest earned on the balance in the Railway Reserve Fund and supplemented by such appropriations from Railway Revenues from year to year as could be possible in view of the overall financial condition of the railways. Furthermore, 25% of outlay in a year on work-in-progress (which could otherwise be liable to payment of dividend) was exempted from payment of dividend for a period of three years.

The Railway Convention Committee of 1973 recommended that the existing arrangements should continue. It further recommended that 50% of capital outlay, on work-in-progress (with some exceptions) be exempted from dividend liabilities. New lines, and P&T wires were also exempted from payment of dividend for a period of three years. The recommendations of the Railway Convention Committee, 1977, were applicable for two years, 1978-79 and 1979-80. In terms of its recommendations, the railways were to pay a fixed dividend to General Revenues on capital invested in the railways as computed annually in lieu of interest charged plus a small amount of contribution. On capital cost of residential buildings, the rate of dividend was fixed at 3.5%. Capital invested before 1 April 1964 was to bear a dividend of 4.5% plus an additional 1% in lieu of passenger fare tax (which was merged with the basic fares in 1961). The rate of dividend on capital invested after 1963-64 was fixed at 6%. These liabilities, however, were subject to certain concessions. For example, 50% of new capital outlay was exempted for a period of three years from dividend iability. There were also concessions in respect of certain lines which were being treated as 'national investments' or where the railways themselves were granting freight concessions. Capital out'ay in respect of strategic and unremunerative lines was fully exempted from dividend liability.

TABLE 22.1

RAILWAY FINANCES—SOURCES OF FUNDS AND THEIR APPLICATIONS

(Rs in crores)

	First Plan 1951-56	Second Plan 1956-61	Third Plan 1961-66	Annual Plan 1966-69	Fourth Plans 1969-74	Fifth Plan 1974-78	1978-79	1979-80 R.E.	1980-80 B.E.
Sources of Funds									
A. Railway Funds (Appropriations from Revenue to various Railway Funds—including interest on balances—and Open Line Works on Revenue Account)	284 08	396.98	634 75	316.64	554.86	700 29	226.04	197.29	242.41
B. Government Funds	141.94	578.67	1140 78	437.67	1027 43	1494 92	351 30	407.99	392.09
(*i*) Increase in Capital-at-Charge	141.94	549.27	1140.77	412 37	794 22	901.01	345.92	376.40	356.00
(*ii*) Loans from Development Fund	...	29.40	..	25.30	99.71	44 24	5 38	31.59	36.09
(*iii*) Loans from Revenue Reserve Fund	...	...	...	...	133.50	549.67	...	..	...
Total (*A*+*B*)	426.02	975.65	1775 52	754.31	1582.29	2195.21	577.34	605.28	634.50
Applications									
C. Expenditure of which									
(*i*) Capital	141.94	549.27	1140.77	418.10	794.55	901.01	345.92	376.40	356.00

(*ii*) Depreciation Reserve Fund	206.50	320.42	360.30	253.00	494.07	479.94	360.19	205.63	230.64
(*iii*) Development Fund	50.53	121.46	131.41	63.69	97.01	76.33	25.94	28.00	24.00
(*iv*) Revenue Reseave Fund	...	...	...	...	2.09	58.97	...	...	...
(*v*) Open Line Works (Revenue)	23.31	52.55	53.36	27.02	35.25	29.48	7.85	9.60	12.08
(*vi*) Repayment on Loans	—	—	29.40	—	14.21	433.23	1.98	—42.10	—38.12
(*vii*) Interest of Temporary Loans	--	1.82	0.53	1.04	17.99	88.92	0.74	10.11	12.45
D. Net Increase or Decrease in Railway Fund Balances									
(*i*) Depreciation Reserve Fund	—20.63	—78.13	33.06	+45.33	+77.92	+79.28	+26.38	+13.57	+10.01
(*ii*) Development Fund	—6.55	+6.19	—6.24	—29.38	—1.25	—1.02	+5.79	—6.06	...
(*iii*) Revenue Reserve Fund	32.45	+6.89	+9.76	—59.11	—3.07	+37.37	...	...	0.01
(*iv*) Pension Fund	—	—	+25.17	+41.57	+70.21	+35.07	7.45	—0.47	+16.25
(*v*) Accident Compensation, Safety and Passenger Amenities Fund	—	--	—	—	—	+30.42	+4.96	+1.23	+1.26
Total of *D*	+5.26	—65.05	—61.75	+2.19	+143.82	+181.12	+44.57	+8.27	+27.5
Percentage of Government Funds to Total Sources	33.32	58.82	64.25	58.02	64.93	68.05	60.85	67.41	61.80
Percentage of Railway Funds to Total Sources	66.68	41.18	34.75	40.98	35.07	31.95	39.15	32.59	38.20

Source: Appendix X of Explanatory Memorandum on the Railway Budget, 1980-81

The Railway Convention Committee (1977) ceased to exist with the dissolution of the Sixth Lok Sabha. Pending the formation of a new Committee and its recommendations, the existing arrangements have continued and effective from 1979-80, the above mentioned concessions (except losses in the working of strategic lines) are being provided to railways in the form of a subsidy from General Revenues.

RAILWAY FINANCES DURING THE PLANS

Finances of the railways leave much to be desired when we view their performance during the planning era The railways, being the biggest commercial enterprise in India, can legitimately be expected not only to contribute to our national economy indirectly in terms of an efficient transportation service, but also to generate a good amount of surplus for economic growth in the country. Such an economic surplus could be used both as a contribution to the general revenues as also to finance the development of the railways themselves. We might begin by looking at the Funds used by the railways for various developmental purposes (that is, purposes other than those of financing the working expenses). Such developmental activities would include addition to capital of the railways, Depreciation Reserve Fund, Development Fund, Revenue Reserve Fund, and the like.

Let us begin with a look at the resource position in general (Table 22 1). We find that internal resources as a portion of the total of funds has stood at a low figure and the gap had to be filled by government funds. Thus during the First Plan the internal funds as a percentage of the total stood at 66 68, but it declined to 41 18 and 40.98 in the Second and Third Plans respectively. During the Annual Plans this ratio showed a marginal improvement (rising from 35.75% to 40.98%), but in the Fourth Plan it again fell to 35.07%. Actually during the Annual Plans, the Fourth Plan and the Frifth plan there were withdrawals from the Revenue Reserve Fund of the amounts of Rs 63.38 crores, Rs 146.03 crores and Rs 682.95 crores respectively. Moreover, a major portion (sometimes the whole of it) of appropriation to the Revenue Reserve Fund has been by way of loans from the General Revenues instead of from the earnings of the railways themselves. The year 1974-75 was particularly hard for the railways on account of various factors including the general strike in May 1974 Since then, however, the percentage of railway funds to total resources has improved to some extent, as seen from the figures for the subsequent years The improvement is creditable because it

has taken place without undue upward revision of railway fares and freight rates (though excise duty on coal electricity generation and diesel was raised).

The same picture again comes to the forefront if we look at the behaviour of Gross Traffic Receipts, Working Expenses and Net Revenue in relation to capital-at-charge (*see* Table 22.2) We find that from the First Plan to 1980-81, capital-at-charge increased from Rs 889.47 crores to Rs 5756.02 crores (that is about 6.5 times). But while gross traffic receipts increased from Rs 287.75 crores to Rs 2545.35 crores (9 times), the working expenses have increased 9.8 times during the same period, indicating the commercial failure of the railways. In the same connection, the net revenue (before the payment of dividend) has been varying within a low range of Rs 48 crores to Rs 282 crores. After meeting the dividend charges, the railways have either been ending with a meagre surplus or even a shortfall. Net surplus as a percentage of capital-at-charge has not exceeded 3.3 and has many times fallen to anegative figure.

TABLE 22.2

RAILWAY FINANCES DURING PLANS—NET REVENUE AND SURPLUS (SHORTFALL) IN RELATION TO CAPITAL-AT-CHARGE

(Rs in crores)

	Capital-at charge	*Gross Traffic Receipts*	*Working Expenses*	*Net Revenue*	*%to (2)*	*Net Surplus or Shortfall*	*% to (2)*
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
First Plan	889.47	287.75	233.72	48.05	5.4	13.48	1.5
Second Plan	1320.78	399.34	320.63	65.85	5.1	18.93	1.4
Third Plan	2170.97	618.78	480.69	124.24	5.7	29.49	1.4
Annual Plans	2973.62	828.59	691.83	122.31	4.1	—19.22	—0.6
Fourth Plan	3535.02	1070.20	919.63	136.04	3.9	21.32	—2.8
Fifth Plan	4447.79	1833.68	1598.90	214.94	4.8	+38.53	0.85
1978-79	5023.92	2151.04	1866.79	260.82	5.2	+36.66	0.73
1979-80 (RE)	5400.32	2354.44	2108.07	253.88	4.7	- 42.10	—0.78
1980-81 (BE)	5756.32	2545.35	2294.47	281.55	4.9	—38.12	—0.66

Source: Explanatory Memorandum on the Railway Budget, 1979-80 and 1980-81

Notes: Figures in columns 2 to 5 are on the basic of annual averages. 'Net Revenue' is before payment to the General Revenues; Column 7 is 'Net Revenue' minus payment to the General Revenues.

The weak health of the railway finances can be judged by looking at the state of affairs of individual railway funds as well. Thus the

Revenue Reserve Fund could be replenished by only Rs 32.44 crores, Rs 7.96 crores and Rs 10.38 crores during the First, Second and Third Plans respectively. During the Annual Plans and the Fourth Plan, there were net withdrawals of Rs 59 71 crores and Rs 3.07 crores respectively. In the Fifth Plan, there was a net accretion of Rs 37.37 crores followed by a stable closing balance of a nominal amount. These recurring and heavy withdrawals have had to be financed by loans from the Government. Since 1978-79, a Deferred Dividend Liability Account has been started. It had a closing balance of Rs 200.43 crores as per budget for 1980-81.

Coming to the Depreciation Reserve Fund, we find that the need to provide appropriately for maintenance and replacement of the depreciated railway equipment and other assets is fully realised, but the overall stringency of resources does not permit a sufficient appropriation under this head Compared with an appropriation of Rs 30 crores (plus a nominal appropriation to the fund from capital and the interest on balance) p.a. up to 1954-55, the figure has been gradually increasing and was Rs 145 crores for the period 1978-79 and Rs 200 crores in 1980-81. Though this increase looks impressive, we must note the fact that prices have also been rising during the plan period and in terms of actual purchasing power the amount being appropriated to this fund is probably not greater than what it was at the beginning of the plan period. The inadequacy of the appropriation becomes more apparent in the light of the fact that the total value of the assets of the railways has increased significantly on account of developmental activities.

Development Fund was started in 1946-47 with an appropriation of Rs 15 crores (consisting of Rs 12 crores from Railway Reserve Fund and Rs 3 crores from the Railway Surplus) and with a closing balance of Rs 14 83 crores at the end of the year. The fund was meant to finance the passenger amenities to begin with. The 1954 Convention decided that this fund was also to cover the housing of Class III employees. But as with other funds, this fund also has been replenished somewhat niggardly For some years, such as 1949-50, 1966-67, 1969-70, 1970-71, 1973-74, 1974-75 and 1975-76, no appropriation to the fund was made from the revenue surplus. Actually for some years (1967-68 to 1970-71, 1973-74, 1974-75, 1975-76, 1979-80, and 1980-81) the entire appropriations to the fund consisted of loans from the general revenues of the Government of India and the railways had to pay interest cost on these loans. Similarly, for other years a major portion of appropriations came from loans from the general revenues. On account of the inadequacy of the appropriations, the

closing balance dipped to a low figure of Rs 1.85 crores in 1957-58 and a *nagative balance* of Rs 1.69 crores for 1958-59 It was only during the years 1962-63 and 1963-64 that quite significant amounts were credited to this fund from the revenue surplus of railways, leading the closing balance to Rs 52.23 crores. But since 1966-67, the fund again dwindled to near exhaustion and since 1973-74 has no closing balance left. Since 1974-75, a new fund has been established, namely, Accident Compensation, Safety and Passenger Amenities Fund which is expected to be built up primarily from surcharge on passengers. At the end of 1980-81 (BE) the closing balance of this is fund is expected to be Rs 39.64 crores.

One important reason for the continuing financial difficulties of the railways is a low level of efficiency in their operations and maintenance. Inefficiency and leakages at different operational levels have to be reduced to the minimum if the financial position of the railways is to regain its health. A failure along these fronts partly explains the low earning capacity of the railways even when the fares and freights have been revised upwards almost every year It is a disturbing fac or that the operating ratios (that is the ratio of total working expenses to gross traffic receipts) are very high (see Table 22.3) and as a resu t the ratio of net revenue to capital-at-charge is very low. Even the budget for 1980-81 puts the operating ratio of railways at only 90.1 per cent and the ratio of net revenue to capital at-charge at 4.9 per cent. It is highly disturbing that for some railway zones the operating ratio actually exceeds 100 per cent and in North-East Frontier Railway, it is as high as 166.6 (for 1980-81 BE). It is only in five zones, namely, Central Railway, Northern Railway, South Central Railway, South Eastern Railway and Western Railway, that during the period 1969-80, the operating ratio has been below 100 per cent and the ratio of net revenues to capital-at-charge is satisfactory only in five zones (namely, Central, Northern, South Central, South Eastern and Western).

It is obvious that in order to improve the financial position of the railways, a number of steps have to be taken. There is a need to maintain good labour-management relationships. Wastage, pilferage and leakages of revenue in various forms have to be plugged. Tracks must be strengthened and signalling and other equipment must be improved. At the same time, the haulage capacity of the railways must be increased by increasing the load per train. To this end, wagons, coaches and locomotives of improved designs are needed. The possibility of introducing extra long and fast passenger and goods trains should be explored. There is need to maintain good

labour-management relationships. Efforts should be made to have a satisfied, honest and efficient labour force. To this end, the legittimate demands of labour should be met. The labour, on its part should realize the importance of improved productivity. Unless an all-frontal attack is made for improving the working of the railways, it will not be easy to take the railways out of their financial difficulties. It is heartening to note that numerous steps are being taken in these directions. Along with increasing amenities for the passengers, there is a phased programme of increasing the carrying capacity of each passenger train by 200 to 300 passengers. For this the type of coaches being manufactured has been cut from 14 to only three. In the due course there would be predominantly one type of accommodation in trains. Also there is a plan to gradually increase the number of double-decker coaches. Efforts are being made to improve the operational efficiency of railways. The Railway Board has been reconstituted with smaller membership and fewer powers. There is a greater decentralisation of decision-making process. Demarcations of certain railway zones have been adjusted for administrative reasons. Phased extension of electrification and welding of tracks, conversion of metre and narrow gauges into broad gauge and extension of diesel haulage are taking place. The problem of loss to the railways on account of what is called the 'social burdens' is being looked into. In 1979-80, the estimated loss of revenue to the railways on account of 'social obligations' was Rs 243.69 crores (Rs 68.09 crores due to loss on Coaching Services and Rs 68.09 crores on account of carrying of goods below cost).

The Railways argue that at least a portion of the social burdens should be borne by the General Revenues. The Railway Convention Committee (1971) had also recommended a review of the matter. Accordingly, a High-Power Official Committee was appointed to study the whole problem and its report is now under study. Similarly, on the recommendations of the Public Accounts Committee 1974-75, a Rail Tariff Enquiry Committee was appointed to look into the task of restructuring of freight rates and fares. Its recommendations are being implemented. The problem of chronic indebtedness of railways to the government has been looked into by another Committee (as recommended by the Railways Convention Committee, 1971) which was appointed to make an *in-depth study of the capital-structure* of the railways. Such a thorough review of the capital-structure of the railways has been undertaken for the first time since the separation of the Railway Finance from the General Finance in 1924. The Committee has recommended that the railways should no

TABLE 22.3

RAILWAY FINANCES—OPERATING RATIOS AND RATIOS OF NET

Railway Zone	*Operating Ratios**					
	1970-71 A/c	*1974-75 A/c*	*1976-77 A/c*	*1978-79 A/c*	*1979-80 B.E.*	*1980-81 B.E.*
1	*2*	*3*	*4*	*5*	*6*	*7*
1. Central Railway	73.0	76.4	70.1	72.7	74.7	74 0
2. Eastern Railway	93.8	116.6	100.0	114.1	113.8	107.7
3. Northern Railway	84.5	100.2	84.6	89.0	86.2	87.4
4. North-East Frontier Railway	141.3	164.8	142.1	146.5	169.2	166.6
5. North-Eastern Railway	101.5	130.1	121.3	118.8	126.2	120.8
6. Southern Railway	99.0	106.4	109.0	113.2	122.3	121.8
7. South-Central Railway	82.1	81.0	78.4	80.4	85.2	87.2
8. South-Eastern Railway	71.3	77.7	64.7	70.1	76.1	75.4
9. Western Railway	74.6	81.5	78.2	74.7	76 3	78.0
All Railways	84.2	93.5	84.4	87.5	90.4	90.1

REVENUE TO CAPITAL-AT-CHARGE

*Ratio of Net Revenue** to Capital-at-Charge*					
1970-71 A/c	*1974-75 A/c*	*1976-77 A/c*	*1978-79 A/c*	*1979-80 R.E.*	*1980-81 B.E.*
8	*9*	*10*	*11*	*12*	*13*
8.8	9.6	15.2	14.2	14.6	15.6
1.5	—6.0	—0.3	—5.1	—6.0	—3 4
4.9	—0.3	7.6	5.4	8.1	7.3
—7.5	—12.9	—12.1	—13.1	—13.5	—12.9
—1.3	—13.4	—12.0	—9.8	—12.6	—10.1
...	—2.0	—3.2	—4 1	—5.4	—5.6
7.5	9.0	12.0	9.2	7.7	6.7
7 0	6.4	14.3	11.2	9 3	10.1
10.0	8.3	11.2	13.1	13.9	13.1
4.3	1.8	6.5	5.2	4.7	4.9

*Ratio of Total Working Expenses (including appropriations to Depreciation *Fund and Pension Fund) to Gross Traffic Receipts.

**Net Revenue is before the payment of dividend to General Revenues.

Source: Explanatory Memorandum on Railway Budget, 1975-76 to 1980-81.

longer be called upon to obtain loans from the General Revenues for meeting shortfalls in dividend payments. Any such shortfall should be treated as deferred liability as and when adequate surplus is generated. This resulted in the creation of Deferred Dividend Liability Account with effect from 1978-79 with a closing balance of Rs 200.43 crores in 1980-81. Further, the accumulated interest portion of the loan liability under Revenue Reserve Fund, amounting to Rs 93.92 crores should be written off. The balance amount of Rs 122.19 crores should be treated as deferred dividend liability. It may be hoped that with such a concerted all-round effort, it should be possible for the railways to overcome their financial and other difficulties.

23 PUBLIC SECTOR IN INDIA

Introduction

We have already seen in detail the theoretical arguments in favour of having public sector industries in a developing economy. We can justify the existence and growth of public sector on grounds of both economic growth and redistributive justice. An underdeveloped country may be in the grip of a vicious circle of poverty. To break out of it, and accelerate the pace of economic growth, a rapid rate of capital accumulation is needed. Left to itself, the market mechanism in an underdeveloped country may not generate enough of savings for capital accumulation. The State has to play an active role in mobilising and effectively utilizing the savings of the economy. The economy's savings are directed towards appropriate lines of investment through the public sector such as social overheads, capital goods, basic and key industries, etc. Private enterprise would not be able to muster huge resources needed for developing these industries and even if it could, the lack of commercial profitability would push the national savings into industries other than those mentioned above. Moreover, once these public enterprises are started, they themselves become a source of capital formation for the economy. Their surpluses can be used for additional investment and expansion of various industries and services. Thus the pace of investment and economic growth can be increased without increasing taxes to a corresponding extent. Actually, even with given tax coverage and rates, the total tax revenue available to the government increases because of the additional contribution which comes from the public enterprises.

Public enterprises have an effective role to play in bringing about a balanced economic development. An underdeveloped country is faced with supply gaps and shortages. With a rational planned approach, the public enterprises can fill these gaps, and provide the necessary 'critical-minimum' push needed to bring the economy to a path of self-sustained growth. Similarly, for a proper economic development, an economy needs what is called the basic infra-

structure. Private enterprise is not in a position to provide the same. Public undertakings can specifically be taken up with that objective in mind. In this manner they provide a major source of external economies to other industries and services.

In order to keep the economy on an even keel and guide it along the right path, the use of public sector is very helpful because of the fact that different industries have close input-output interdependence. The economy can be guided and regulated with the help of basic and key industries, such as steel, cement, petroleum, heavy chemicals, etc. By having these industries in the public sector, the authorities can use them as a lever to control the rest of the economy also. The marketing and pricing policies of these industries will profoundly affect the way in which the rest of industries can and do operate. Moreover, public enterprises can be an important means in ensuring economic justice.

Public Sector in India

The idea of public enterprises was not a new one for India even before independence. But the Industrial Policy Resolutions of 1948 and 1956 laid the foundations for a systematic and rapid growth of public enterprises in their diverse forms. Public sector has been given a leading role in our successive plans with a view to using the public enterprises for achieving various plan objectives. They are not only expected to provide a sizeable economic surplus for accelerating our economic growth, but also to help the private sector in a balanced economic growth. They are also expected to make an important contribution towards our achieving a socialistic pattern of society through their multifold role of providing an infrastructure, acting as an ideal employer and well-wisher of the workers and so on. In 1966, the Prime Minister proclaimed the objectives of public sector in India as follows: "We advocate a public sector for three reasons : to gain control of the commanding heights of economy; to promote critical development in terms of social gain of strategic value rather than primarily on considerations of profit; and to provide commercial surpluses with which to finance further economic development."[1] In India, the rapid growth of public sector is mainly the result of new investment and creation of new concerns. Nationalisation of existing concerns has been only up to a limited extent, the prominent areas of nationalisation being banking, coal and insurance. Some concerns like sick cotton textile mills have been

[1]Quoted in *Lok Udyog*, June 197 6.

taken over for rehabilitation. All told, by the end of 1978-79, investment in 176 public enterprises (non-departmental) amounted to Rs 15602 crores with a turnover of Rs. 18936 crores and gross profits of Rs 1075 crores. They were providing direct employment to 1.87 million persons.

Public enterprises in India are of various kinds and forms. For the purposes of our discussion they may be divided into two categories:

(*i*) In the first category we have those public enterprises which are run as departments or by the departments. They may be called the departmental public enterprises. Examples of such enterprises are Railways, Posts and Telegraphs, All India Radio, Ordnance factories, etc. Other important departmental enterprises would include Ghazipur Opium Factory, Tarapur Atomic Power Station, Rajasthan Atomic Power Station I, Nuclear Fuel Complex, Overseas Communications Service, Bank Note Press, Security Paper Mill etc. Incidentally, the latter-mentioned enterprises are contributing far larger profits (relative to the capital investment in them) than the railways and P&T.

(*ii*) The second category covers those public enterprises which are run outside the Government and are referred to as the non-departmental commercial enterprises.

Let us start with the first category. Railway finances have already been discussed in an earlier chapter. It was pointed out there that the railway finances were separated from the Central Budget on the basis of the Convention of 1924. They pay a dividend to the Central Government in addition to an interest on borrowed funds. Similarly, P&T have been paying a dividend to the Central Government since 1960.[2] Their contributions to the General Revenues under the revised Convention effective from 1 April 1970 are determined on the following basis :

(1) The department pays a dividend at the rate of 4.5% on the net capital advanced by the Government up to the end of 1963-64 reduced by the Department's share of accumulated surpluses as on 31 March 1960 (which were Rs 29.78 crores) and further reduced by the balance of the Department's Renewals Reserve Fund as at the end of 1963-64 (which was Rs 52.72 crores). On the capital advanced between 1 April 1964 to 31 March 1970, minus the net accretion to the Renewals Reserve Fund during the same period, the dividend payable is to be calculated at 6%.

[2]Of course, the receipts and expenditures of these departments are included in the aggregates of the Central Budget.

TABLE 23 1

FINANCIAL WORKING OF POSTS AND TELEGRAPHS DEPARTMENT

(Rs in crores)

Item	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977 78	1978-79	1979-80	1980-81
1	2	3	4	5	6	7	8	9	10	11	12
1. Revenue Receipts	271.1	299.8	321 0	360.8	401.6	483.61	619.27	668.19	762.83	870 10	950.30
2 Working Expenses (net)	235.0	249.7	269.5	310.4	378.1	462 63	491.08	511.21	585.63	654 00	710 84
3. Net Receipts (1−2)	36.1	50.1	51.5	50.4	23.5	20.98	121.19	156.98	177.20	216.10	239.46
4 Dividends to General Revenues*	13.2	13.0	14.4	22 3	21.2	25.39	28.56	29.95	31.32	32 75	35.42
5. Surplus (+)/Deficit (—) (3—4) *of which*	+22 9	+37.1	+37.1	+28 1	+2.3	−4.41	+99.63	+127.03	+145.88	+183.35	+204.04
(*i*) Postal Services	—	—	—	15.5	−35.8	−47.74	−32.04	−1.98	—2.27	5.75	9.09
(*ii*) Telecommunication Services	—	—	—	+43.6	+38.1	+43.33	+131.67	+129.01	143.61	177.60	194.95

Appropriation to (+) or
Withdrawal from (—)

*Details regarding the determination of Dividends payable to General Revenues are given in the text.

Source. RBI, *Report on Currency and Finance*, 1974-75 and 1975-76, and Explanatory Memorandum on Central Government Budget, 1978-79, 1979-80 and 1980-81.

(2) On the capital advanced from 1 April 1970, the Department pays dividend at the rate of 6%, but no reduction is made in the capital for this calculation. Furthermore, since 1 April 1970, the aggregate liability of the Department to the General Revenues so calculated is adjusted for the difference in interest at Dividend rates and Average rates on the balances in Capital Reserve Fund and Revenue Reserve Fund. If the Department is not able to meet its dividend obligations to the General Revenues, the Government makes an interest bearing advance to the Posts and Telegraphs Reserve Fund to enable the Department to cover the shortfall and meet the deficit, if any, in the working results of the Department. Provision for Depreciation based on historical cost of assets is transferred to Capital in reduction of the outlay. Additionally the Department makes an annual contribution to its Capital Reserve Fund out of its own earnings. Since 1 April 1970, the Capital Reserve Fund also earns interest at the Average Rate of Interest which is added to the Fund itself.

Table 23.1 depicts the financial working of the P & T Department for the last few years. It is seen that the postal services have generally been a source of deficit throughout while the surpluses have been earned by the telecommunications. Further, the budget estimates for 1979-80 show an unprecedented improvement in the financial working of Department. While 1975-76 there was a deficit on revenue account amounting to Rs 4.41 crores, there was an increasing surplus in the following years. The budget for 1980-81 anticipated a surplus of Rs 204.04 crores. This is partly on account of the sharp improvement in revenue receipts which were put at Rs 483.61 crores in 1975-76 but were estimated to jump to Rs 970.30 crores in 1980-81. This sharp increase in revenue receipts were due to the increase in receipts of rents of wires/circuits leased to Railways, Canals, etc. as also revision in P&T rates. The tariffs in receipts of certain inland telephone and postal services were drastically revised upwards with effect from 1 March 1976 followed by further revisions later on. The working expenses have also been increasing due to higher establishment charges, larger payments to Railways for haulage and so on.

The finances of the remaining departmental undertakings are not separated from the main budget of the Central Government. Table 23.2 presents a comparative position of Railways, P & T and other concerns regarding their contributions to the revenue receipts of the Central Governments by way of profits and dividends and interest. The contributions by way of profits and dividends are also primarily

TABLE 23 2

DIVIDENDS AND PROFITS AND INTEREST RECEIPTS FROM DEPARTMENTAL UNDERTAKINGS

(Rs in crores)

	1969-70	1970-71	1971-72	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80 (RE)	1980-81 (BE)
Dividends and Profits from												
(i) Currency, Coinage and Mint	25.93	25 59	30 11	29 57	31 63	35 70	50.14	67.24	72 74	95 24	121.49	133 18
(ii) RBI	70.00	75 00	100 00	120 00	130 00	145 00	150 00	190.00	200.00	200 00	200 00	210 00
(iii) Railways	28 10	26 36	19 78	17 98	(—) 0 16	25.68	6 49	3 38	1 20	—4 36		.
(iv) Posts and Telegraphs	2 81	2 68	2.37	2.50	2 44	1 03	1.68	2 31	—0 27	1 59	0 82	
(v) Others	21. -	16 59	22 11	23 57	25 12	36 46	36 84	57 21	77.99	66 36	95 78	79 20
Total	148 66	146 22	174 37	193 62	189 03	243 87	245.15	320 14	351 66	358 83	418 09	422.38
Interest Receipts on												
(i) Railways Capital	128 29	138 22	131.46	143.53	155.30	177 58	191 65	232 94	253 57	227 76	253 87	281.55
(ii) P & T Capital	10 03	10.51	10.65	11.89	19 89	20.16	24.23	27 63	30 22	31 44	31.93	35.42
Total	138 32	148 73	142 11	155 42	175 19	197.74	215 38	260 57	283 79	259 20	285 80	316 97
Grand Total	286 98	294 95	316.48	349 04	364 22	441 61	461 03	580 71	635 45	618 03	703 89	739 35

Source Explanatory Memorandum on the Budget of the Central Government, 1976-77 to 1980-81

accounted by those of RBI and Currency, Coinage and Mint. The contribution by Railways (to which go the maximum of capital investment) is quite nominal. Same is the case with P&T. The contribution by these two concerns is mainly in terms of interest on their capital. It goes without saying that the departmental undertakings must improve their performance.

The other category of public enterprises includes those concerns which are run outside the Government. They are either companies or corporations. As companies, these enterprises are registered under and regulated by the Indian Companies Act. The company form is supposed to carry certain advantages over departmentally run enterprises. *Firstly*, the departments do not allow adequate freedom of action to the management. Every action has to be taken under set rules and regulations and there is no scope for initiative or innovation The company form of organisation allows a flexibility and freedom to the management. *Secondly*, a company form enables the concern to see and be constantly aware of the fact that it should work for commercial profits. It has an inherent tendency to adopt sound commercial policies and such an approach is considered quite natural for a company. A department, on the other hand, is viewed more as an organ of the government designed for the service to the society without any commercial motive. *Thirdly*, in comparison with departmental undertakings, a government company can enforce a stricter code of discipline both for the workers and the managers. *Fourthly*, a company has a greater flexibility in managing its finances and can take appropriate decisions in the light of changing market conditions. It can adopt a more realistic price policy designed to earn commercial profits while serving the community. Furthermore, unlike a departmentally run enterprise, a company need not be fully owned by the government.In India, an ownership of 51% of equity capital by the government would make it a government company. This means that government can acquire and control the working of a company while letting other parties contribute up to 49% of the equity capital. Such a possibility enables the government to expand public sector at a relatively smaller investment of the public funds. It also implies the possibility of tapping the managerial, technological and other resources of other parties. In India, there is a plan to allow private investment in public enterprises on a minority basis. This step would enable the authorities to tap private savings and provide investors a wider opportunity. If the employees themselves choose to participate in the equity capital of public enterprises it will bring about a greater sense of responsibility and an impetus to efficiency. Moreover, com-

pared with financing of public enterprises through deficit financing, this method does not add to inflationary forces.

Public corporations are established by specific Acts of Parliament. According to our Constitution, a corporation can be set up only by the Central Government even if it is meant to serve only a State. The functions, duties and rights of a corporation are determined by the relevant Act. A corporation is a legal entity. It can sue and be sued. An important feature of corporations is that for each corporation an organisation suitable to its purposes can be devised. It gets necessary freedom to devise and adopt its own personnel policy and a system of rewards and punishment for an efficient working. The sources of finance of the corporations are not uniform. Some non-commercial corporations get their initial capital through parliamentary appropriations either as an outright grant or as capital bearing nominal interest. Some corporations get their capital in the form of share capital owned wholly or largely by the government with or without subscriptions by other institutions like the Reserve Bank of India, etc. These corporations may also supplement their funds by issue of debentures and loans.

It must be remembered that a public enterprise may be owned partly or fully by government at any level (Central, State or Local) except that a corporation can be set up only by the Union Government. Furthermore, as pointed out earlier, in the case of a company, the ownership of equity capital need not be fully in the hands of the government. In some cases, a company may be owned by more than one government (such as the Central and State Governments); or by the governments (holding the majority shares) together with other parties.

There was only five non-departmental undertakings of the Central Government with an investment of Rs 29 crores as on 1 April 1951, but their number increased to 21 (with an investment of Rs 81 crores) by 1 April 1956. By the end of the Second Plan, that is on 1 April 1961, the number of such enterprises rose to 48 with an investment of Rs 953 crores. It was an annual increase of 233% in their numbers. During the Third Plan, and later, the numbers of such enterprises rose less rapidly, but increase in investment continued at a high rate. By the end of the Third Plan, that is the end of March 1966, there were 74 public enterprises with an investment of Rs 2,415 crores; the end of Annual Plans of 1966-69 found their number at 85 with an investment of Rs 3,902 crores, while by the end of Fourth Plan we had 122 enterprises with an investment of Rs 6,237 crores. By the end of 1978-79, we had over 176 under-

takings with an investment of Rs 15,602 crores, of which there were 159 running concerns with an investment of Rs 14173.38 crores.

It may be noted that at the end of March 1979, the investment (including paid-up capital and long-term loans) of the Central Government in these public undertakings was Rs 13365 crores (out of Rs 15602 crores), the rest having been contributed by private parties (foreign parties, Rs 900 crores and Indian parties, Rs 1308 crores (and State Governments (Rs 30 crores).

Public enterprises are well dispersed into different economic fields and have therefore come to occupy an indispensable place in the economy. They are well-knit with the rest of the economy and a virtual vertical integration has come about between public enterprises and the private sector such that the public enterprises now occupy the commanding heights. The public sector is now able to directly influence the working of the private supply through its pricing, marketing and production policies. Public enterprises dominate a number of basic and key industries such as steel, minerals and metals, chemicals and pharmaceuticals, heavy engineering and the like. Financial dimension of the economy is covered by governmental financial institutions. Through nationalisation of the major commercial banks, and investments in various other financial institutions, the government is able to reach the nook and corner of economic activities of the country. With a judicious use of the public sector enterprises, the government is in a position to dictate its policies to the private sector and toe it along.

To substantiate the foregoing comments, let us look at some of the relevant figures relating to non-departmental running public sector enterprises. These enterprises may be broadly grouped into those producing goods and those rendering services. In the former category (with 91 enterprises) the total capital employed stood at Rs 9699.03 crores at the end of 1978-79 and showed 1.5% return on the capital employed. The category included agro-based products, petroleum, medium and light engineering, heavy engineering, transport equipment, consumption goods, chemicals and pharmaceuticals, steel and minerals and metals. Similarly, the enterprises rendering services included production and marketing services, transportation, and so on. Against an investment of Rs 2693·0 crores these 49 enterprises recorded profits of Rs 55.08 crores (or 2.04 per cent of investment). (*see* Table 23.3). However coal, textiles, and DTC showed heavy losses.

From Table 23.3, we can easily comprehend the diversity and range of public sector undertakings in India. However, it may still be

TABLE 23.3

NON-DEPARTMENTAL COMMERCIAL UNDERTAKINGS OF GOVERNMENT OF INDIA

(Rs in crores)

	1977-78				1978-79			
	No. of Cos.	Investment	% of total capital employed	Profit	No of Cos.	Investment	% of total capital employed	Profit
1. Cos. under construction	11	962.37	7.2	—3.98	10	1096.14	7.1	38.65
2. Enterprises producing and selling goods								
Steel	4	3056.62	22.8	—41.68	2	3102.29	19.1	0.77
Minerals and metals	14	920.60	6.9	29.02	13	1158.12	7.4	173.19
Petroleum	11	816.86	6.1	—54.39	10	893.21	5.7	—27.04
Chemicals & Pharmaceuticals	11	2122.60	15.9	—46.20	15	2737.51	17.5	—38.94
Heavy engineering	10	826.65	6.2	14.49	11	927.33	5.9	15.03
Medium & light engineering	17	242.79	1.8	—6.10	18	262.22	1.7	—4.31
Transportation equipment	9	367.55	2.7	—5.38	9	498.71	3.2	—6.06
Consumer goods	9	91.26	0.7	—1.83	9	104.26	0,7	—3.03
Agro-based enterprises	4	14.01	0.1	—16.15	4	15.38	0,1	148.28

3. Service enterprises								
Trading & Marketing	21	565.09	4.2	38.89	21	614.48	3.9	32.55
Transportation	7	1079.59	8.1	25.89	7	1254.08	8.0	9.96
Contract & construction	7	48.13	0.3	1.30	7	72.95	0.5	0.39
Industrial development and technical consultancy	7	6.83	0 0	4.31	8	15.28	0.1	1.33
Development of small industries	1	33.77	0.2	−0.91	1	31.39	0.2	−1.14
Tourist services	2	20.92	0.2	1.62	2	24.60	0.2	2.29
Financial services	3	520.28	3.9	7.60	3	681.01	4 4	9.71
4. Coal India Ltd. and its subsidiaries	5	1155.33	8.6	−100.00	5	1512.55	9.7	−212.16
5. National Textiles Corporation and its subsidiaries	10	396.41	3.0	−41.17	10	439.12	2.8	−8.36
6. Delhi Transport Corporation	1	67.94	0.5	−16.17	1	79.69	0.5	−17.49
7. Cos. Regd. under Sec. 25	2	6.21	—	3.72	3	13.24	0.1	2.71
8. Insurance companies	7	67.19	0.5	0.15	7	68.54	0.4	...
Grand Total	174	13389.18	100.0	−91.07	176	15602.10	100.0	−31.96
Grand Total (excluding coal)	169	12233.85	8.93	91.4	171	14089.55	90.3	180 02

pointed out that the bulk of total investment 57.2%) in 1978-79 is accounted for by top ten enterprises. This indicates that public enterprises are yet to penetrate the main layers of the Indian economy. Similarly, if we look at the regional distribution of investment in public enterprises, we do not find any definite correlation between it and low per capita income. This dimension of the public enterprises also points out the more positive role which public enterprises can play in removing regional imbalances.

Some Problems of Public Sector Undertakings

Public enterprises are not free of difficulties. They have to work under certain limitations such that performancewise their rating is sufficiently low.

(1) The first such limitation is the lack of clear-cut objectives. As stated earlier, public enterprises are expected to help and guide the economy in numerous ways. However, any given public enterprise can be expected to have only a limited objective or objectives in view, such as creation of an investible surplus for authorities or for internal expansion, providing a promotional infrastructure and the like. In many cases, a public enterprise is not clear as to what objective (or objectives) it is expected to pursue. Furthermore, at one time it might be accused of not pursuing one particular objective, and at another time some different objective. Or it might be expected to pursue various objectives in general which could be contradictory and mutually exclusive. In such a situation, the enterprise could not simultaneously achieve a high degree of efficiency with respect to all of them.

(2) Such a nebulous and hazy state of affairs tends to hide the inefficiency, if any, of the public enterprises. The management,. when accused of inefficiency in terms of one objective (say producing a surplus) tries to explain away the matter with reference to other possible objectives. Various excuses are found out to show that the circumstances were 'beyond the control of management.' Similarly, the price policy adopted by an enterprise may be designed to subsidize the consumers of its goods or service even when the overall economic policy of the country does not dictate so. Or the case may be the other way round. In order to cover its general inefficient working, the enterprise might be charging monopoly prices in the name of 'rationalising prices' or ensuring 'a fair rate of return' on invested capital.

(3) Public enterprises in India are intricately interwoven with each other and private enterprises through input-output relationships. They

have a demand for each other's products and depend upon mutual demand supply relations. The result is that an inefficient working of one enterprise tends to spread its effect on to other enterprises also. When supplies from one enterprise are delayed, are high priced, are of inferior quality, or suffer from any such defect, a chain reaction takes place and quite a few other industries (including public enterprises) suffer. Since most of the key and basic industries are in the public sector, their inefficient working causes much larger damage than would otherwise be the case. One can well imagine the ill-effects of inefficient working of the railways, steel fertilizers, power generation and the like.

(4) Public enterprises, even when they are companies or corporations, are not in a position to devise a high-grade system of punishment and incentives. In order to operate the enterprise at top-most efficiency, it is essential that its managers and other employees should be rewarded suitably, through promotions and additional emoluments, when they work harder and show an initiative and integrity. Similarly, negligence of duty should be duly punished. However, it so happens that management personnel in these enterprises do not have any incentive to take initiative and try out new and better ideas. On the one hand, they are liable to explain their actions if they deviate from the set practice (even if the result of the initiative is good); and on the other hand, they do not lose anything if no initiative and enterprise is shown. The result is that the management personnel think it best to play safe and work only within the set practice. The workers also find themselves in more or less similar position. On account of the fact that these enterprises are expected to be ideal employers, the workers are provided a security of service. To protect individual workers from victimisation and to prevent the extension of undue favours to others, set rules for promotion, etc. are often laid down. All told, a worker also finds that he has nothing to lose so long as he operates within the technicalities of the rules and regulations and that he cannot hope to gain if he tries to work harder. The whole system is further supported by trade unions which find that they can get more concessions for their members not through increasing productivity of the concern, but only through militant pressures.

(5) It is claimed that public enterprises in India are burdened with inefficient and expensive managements. The appointments to top positions are not always made on grounds of merit and efficiency only. The top managers do not have any personal stake in ensuring the success of the enterprise. Moreover, these top positions are generally transferable from one concern to the other. The result is that before

the person at the helm of affairs is able to fully grasp the problems of the concern and is able to devise long-term measures for solving them, he either retires or is transferred to another job. On top of it, it is generally believed that there is outside interference in the management of these concerns. Furthermore, as pointed out above, the management in public enterprises is top heavy. The number of managers is about one-tenth of the number of workers employed in these concerns. And this is in addition to a general overstaffing of these undertakings.

(6) Indian public enterprises, it is claimed, have by and large long gestation periods—that is to say, the very nature of investment is such that it takes a long time before production starts and an enterprise can yield a return. This claim, it must be remembered, is only partly true. We must note that all public enterprises in India are not in the gestation stage only. Most of them are already running concerns and can be legitimately expected to yield a commercial surplus. However, it is found that most of the older concerns have accumulated losses and are still not working quite efficiently. Apart from the railways, one can mention steel industry, minerals and metals, chemicals etc.

Performance

The actual performance of public enterprises leaves much to be desired. Since public enterprises may be judged from various angles, we shall first look at them in terms of their qualitative performance and then look at their quantitative performance. Qualitative performance may be judged in terms of quality of the product, its pricing and the utilisation of productive capacity. It is generally felt that qualitywise, it is a mixed affair with public enterprises. Products of some enterprises are of quite high standard and can even compete in international markets while those of others can be termed inferior. By and large, there is a greater need for improvement in quality in the case of services than in the case of goods. It is generally felt that a lot of improvement is needed and is possible in the performance of service enterprises, such as transportation, trading and marketing. Performance on the pricing front is more difficult to judge. Whether or not a particular public enterprise is trying to exploit the consumers or is trying to camouflage its inefficiency through higher prices is a matter of opinion until a systematic study of the actual costs is made and the possible economies in the cost of production are worked out. As a result, no sweeping statement is possible in this regard. Each case has to be studied separately and the results arrived at.

However, the performance of a public enterprise can also be judged on the basis of its capacity utilisation. Here, unfortunately, the

public enterprises have a sorry picture to present. A study of 147 units by the Bureau of Public Enterprises in its Annual Report for 1978-79 shows that only 62 units were operating at 75% or more of their productive capacity, 42 units were operating between 50% and 75% capacity and 27 units were operating at less than 50%. The official viewpoint is that the following seven causes affecting capacity utilisation, namely : power shortage, fluctuations and failures; industrial unrest; lack of balancing equipment; equipment breakdown; inadequacy of demand; inadequacy or poor quality of raw material ; and design deficiencies. But the study fails to mention the human factor and the government measures also fail in that respect. An all-round administrative laxity, an absence of a system of reward and punishment, a lack of concern for the efficient working of the organisation; decision taken on non-economic and non-technical grounds and militant trade unions are all contributing to the poor performance of these enterprises including their low capacity utilisation. Apart from low capacity utilisation, there is also the charge that in public enterprises the maintenance of plants and machinery is quite poor and this entails heavy expenses and even pilferage. Party this poor maintenance is associated with lack of experience and technical knowledge of the processes involved. Public enterprises are also accused of a lethargic sales effort resulting in avoidable delays and loss of revenue. There is also the chronic problem of bureaucrats occupying the highest positions in these enterprises, often as deputationists. This fails to create a sense of belonging and long-term perspective in the top officials.

Let us now look at the performance of public enterprises from commercial point of view. With the absorption of huge public funds these enterprises are legitimately expected to yield a good amount of investible surplus which may be used for their own expansion or as a contribution to the public revenue. Such a commercial surplus should enable the authorities to expand public sector without at the same time increasing the burden of taxation upon the economy. On this score, however, public enterprises have failed miserably. Actually, instead of contributing surplus to the public revenues, they have been running into losses. By the end of 1973-74, their accumulated losses totalled Rs 778.55 crores. It is only in 1972-73, that these concerns showed a collective net profit (after tax) of Rs 18 crores against a loss of Rs 19 crores in 1971-72 (*see* Table 23.4). The ratio of turnover to investment crossed 100% only in 1973-74. The result is that return on equity was negative till 1971-72 and was only 0.6% and 1.9% in 1972-73 and 1973-74 respectively. The position of collective

net profitability, however, was again replaced by a collective net loss in 1977-78 to which coal companies made a substantial contribution. The result has been a poor return on capital employed. And as seen above, the picture of capacity utilisation has been an equally dismal one.

It is not implied that there is nothing on the credit side of the public enterprises. In spite of their many sided short-comings, they have an economic and social rationale and a useful purpose to serve.

TABLE 23.4

SOME IMPORTANT INDICATORS OF THE WORKING OF NON-DEPARTMENTAL CENTRAL GOVERNMENT PUBLIC ENTERPRISES

	1968-69	*1971-72*	*1975-76*	*1976-77*	*1977-78*	*1978-79*	*1978-79**
A	66.07	99.65	255.13	394.37	384.85	484.75	484.75
	(41)	(58)	(87)	(93)	(81)	(88)	(88)
B	94.20	118.61	126.02	210.48	472.92	516.71	304.55
	(32)	(35)	(34)	(56)	(73)	(69)	(64)
C	−28.13	−18.96	129.11	183.99	−91.07	−31.96	180.20
	(73)	(93)	(121)	(149)	(155)	(159)	(154)
D	95.00	146.78	362.81	606.86	755.13	882.46	818.20
E	18.00	41.27	176-54	236.86	250.61	225.41	225.41
F	85.00	169.00	668.46	1027.61	914.67	1075.91	1223.81
G	3168.00	4089.00	8824.30	10887.14	12130.20	14173.38	12428.39
H	2.80	4.06	7.58	9.44	7.54	7.59	9.84
I	149.00	219.00	345.39	462.71	574.49	697.05	646.51
J	234.00	388.00	1013.85	1490.32	1489.16	1772.96	1870.32
K	7.50	9.60	11.49	13.69	12.27	12.51	15.04

A. Net profit earned by running concerns (number in brackets).
B. Net loss incurred by running concerns (number in brackets).
C. Total net profit/loss.
D. Total interest.
E. Total corporate tax paid.
F. Total gross profit ($C+D+E$).
G. Total capital employed (fixed assets less depreciation plus working capital).
H. Gross profit (%age) to capital employed.
I. Depreciation.
J. Gross margin ($F+I$).
K. Gross margin (%age) to capital employed.
* Excluding coal components.

Source · Annual Report on the Working of Industrial and Commercial Undertakings of the Central Government, 1978-79.

They have created in our economy an infrastructure needed for a rapid and balanced economic growth. They have been able to make

private enterprise extensively dependent upon the public sector so that the government has now an effective lever in its hands to direct and manipulate the economy for achieving the chosen economic and social goals. There are indications that public enterprises can come out of their patent difficulties and show positive results if their management can be improved. In 1978-79, their contributions to the Central Exchequer were Rs 2986 crores (as against (Rs 1802 crores in 1977-78). This was made up of dividends (Rs 76 crores), interest on Central Government loans Rs 371 crores), income tax (Rs 226 crores), sales tax (Rs 476 crores) and excise duty (Rs 1751 crores). However, while putting the argument in this manner, we should remember that had the same funds been invested in the private sector there would have been profits in the hands of private sector in addition to the tax revenue with the authorities. It should, therefore, be legitimately expected that the authorities should get both tax revenue and commercial surplus (in the form of profit and dividends) from the public enterprises. Unfortunately, the profit (dividend) income of public enterprises has been quite small.

The need for an improved performance of public enterprises cannot be overestimated. To this end, some steps should be helpful. There should be a reduction in their inventory holdings. Schemes of worker's participation and the formation of shop councils and joint management councils should be implemented. There should also be a more prudent use of the working capital and other resources of the enterprises including a better utilization of their productive capacity. The Bureau of Public Enterprises aims at a gross profit of 12.5% on the total capital invested in the public undertakings. In order to achieve these targets the public enterprises would have to ensure that undue expansion in working force does not take place, and wage revisions are in some way interlinked with labour productivity. Top heavy management must be converted into a more efficient and less costly one. It may be mentioned here that a Public Enterprises Selection Board has been formed with idea of injecting professional expertise at the managerial level. Similarly, an important institution designed to improve the working of public enterprises is the Bureau of Public Enterprises. It was set up on 5 April 1965. To begin with, the Ministry of Commerce and Industry which had the largest number of public enterprises under it, thought of a Coordination Committee for Industrial Projects. Soon, however, the charge of public enterprises passed on to various relevant ministries. However, when a persistently bad financial performance by a majority of them was noticed, the Estimates Committee recommended the setting up of the

Bureau of Public Enterprises which was set up in the Ministry of Finance. Its main tasks include providing consultancy on important aspects of management, finding out ways of reducing the capital costs and improving productivity and profitability of the enterprises. It also reviews the working of the public enterprises and reports to Parliament. Since 1969, the Bureau also conducts study of the feasibility reports and many other ancillary tasks intended to help the public enterprises on an overall basis in reducing costs, preventing disparities in emoluments and amenities to the employees as between different enterprises and the like. Furthermore, the Bureau is a central place where all the relevant information regarding public enterprises gets collected. It, therefore, helps in chalking out appropriate price policies and bringing about useful original changes. It also helps the Public Investment Board in respect of proposals for new investments, and the Public Enterprises Selection Board in selecting appropriate personnel.

Pricing Policy

Public enterprises cannot have a uniform price policy due to various reasons. For example, the objectives of different public enterprises may vary. Some enterprises, like those producing and marketing essential food items cannot be expected to indulge in profiteering. Rather in some cases, the social criteria may dictate subsidizing the consumption of such items. Similarly, certain industries cannot be allowed to exploit the market when scarcity conditions prevail because this action of theirs will have large scale repercussions on other industries. Thus, if there is a shortage of steel, and steel prices are allowed to shoot up, there would be an all round increase in cost of production. Another reason for lack of uniform price policy is that identical costing techniques cannot be applied in every case. While some projects would admit of marginal cost pricing, others would not.

Due to the above-mentioned causes and the fact that in India even the objectives of public enterprises are not always clearly defined, pricing policies as pursued by different enterprises are not uniform. One may even say that in some cases, a set price policy just does not exist. In some cases, the enterprises themselves do not have an authority to choose their own prices. Thus, the government controls and even fixes the prices of some basic industrial products like those of steel, cement, fertilizers coal, and the like. The prices so fixed may or may not have a close relationship with cost of production and, therefore, may or may not result in a profit for the enterprise

under consideration. In some cases, the price may be quite uneconomical from the point of view of the enterprise either because the cost of production is genuinely high or because the enterprise is working inefficiently. In others the prices so fixed by the authorities may just enable the public enterprises to break even while in still others they may permit a surplus.

Even those concerns which are left to themselves to choose their prices are not adopting a uniform policy. Depending upon the historical evolution, a particular concern may just be expected to work at no profit no loss basis or may be following a policy of 'mark up,' that is, adding a percentage to the cost of production. It is obvious that no generalization can be made about the correctness or otherwise of the price policies being pursued by the public enterprises in India. Each case is to be judged on its own merits in the light of the objectives it is expected to pursue, the level of operational efficiency it has achieved and the like.

Accountability

An intricate problem faced by public enterprises is to reconcile the demands of accountability and autonomy. Autonomy in managing and running the concern is needed to ensure a high degree of efficiency. Without such a freedom to the management in choosing its policies, the decision-making processes, wage policy and the like, the flexibility in management is lost and efficiency in its diverse aspects cannot be ensured. On the other hand, since public undertakings are using public funds and since they are meant to work for social purposes, it is necessary that the independence of the management be curbed and that it should be accountable to the public (through the legislature). It is difficult to achieve a golden mean that would be able to serve both the above-mentioned ends. There will have to be a compromise between the two opposite pulling forces. An ideal exact pattern cannot be prescribed. In any case, there is likely to be a shortfall in terms of achievements at both the ends. Furthermore, whatever the form of accountability, the final result depends upon both the way the system operates and the human beings operating the system. With efficient, conscientious and honest managers and workers, a public enterprise will show an excellent performance if adequate autonomy is granted to the enterprise and minimum accountability restrictions are imposed. On the other hand, in the case of inefficient and unscrupulous personnel manning an enterprise, a detailed system of accountability would be more helpful.

In India, public enterprises are subjected to a rigorous financial

scrutiny. They are subjected to a thorough auditing of accounts. Additionally, the legislature exercises its authority through questions and debates, and by receiving reports on the working of these concerns as also through the examination by the Committee on Public Undertakings. Until 1956, Parliament had no opportunity to discuss the working of the government companies even though it was sanctioning moneys for them and their accounts were being audited by the Comptroller and Auditor General of India. Before the setting up of the Committee on Public Undertakings the public undertakings were subject to an examination by the Public Accounts Committee and the Estimates Committee. After 1956, the Public Accounts Committee started examining, in addition to the statements of accounts of the autonomous and semi-autonomous bodies (along with the reports of Comptroller and Auditor General on them), the statements of accounts of government companies as well. It was, however, by its very nature, an examination of what *had* happened and Parliament did not get an opportunity of expressing its desire with regard to the ways these companies should be made more fully responsive to the wishes of the society. In 1957, therefore, a sub-committee of the Estimates Committee was formed to go into the question and in due course the Committee on Public Undertakings was formed on 21 May 1964. However, the very powers of the Committee on Public Undertakings meant to ensure full accountability spelt out the weakness of the system also. The management of a concern, under this scrutiny, can be called to account for even individual decisions and even those decisions which do not affect the profitability of the undertaking. This breeds a tendency on the part of the management to adopt a policy of no-initiative. It is forced to choose a course of action which may not be appropriate in the light of the circumstances, but which can be explained later on.

24 STATE FINANCES

Introduction

We have seen in an earlier chapter the financial powers which our Constitution provides to the State Governments and therefore the tax and non-tax revenue which a State can raise. Let us briefly look at the heads of revenue and expenditure of the States categorywise. As in the case of Central Government, a State Government budget is also divided into revenue and capital accounts. The capital account deals with the acquisition and disposal of capital assets and liabilities like loans, investments, properties etc. Revenue account, on the other hand, covers the current receipts and expenditure which are in the nature of recurring items.

Revenue Account. Revenue receipts are broadly divided into two parts, namely, tax revenue and non-tax revenue. The tax revenue consists of both the taxes levied by the State itself as also the revenue from taxes shared with the Central Government. The States themselves impose a number of taxes. Some of them have agricultural income tax and the professions tax. They have also taxes on property and capital transactions like stamp duties and registration, land revenue, surcharge on cash crops, and tax on urban immovable property. Similarly, State taxes on commodities and services include sales tax, State excise duties, taxes on vehicles, taxes on goods and passengers, electricity duties, entertainment taxes and others.

A few taxes are levied and collected by the Central Government, but their net proceeds are assigned wholly or partially to the States namely, taxes under Article 269 income tax, and union excise duties. Article 269 of the Constitution lists seven entries on which the Centre may impose taxation and assign the entire net proceeds to the State Governments. They are:

(*a*) Estate duty on properties other than agricultural land;

(*b*) Terminal taxes on goods and passengers carried by railways, sea or air;

(*c*) Succession duty on properties other than agricultural land;

(*d*) Taxes on railway fares and freights;

(*e*) Taxes other than stamp duties on transactions in stock exchanges and future markets ;

(*f*) Taxes on sale or purchase of newspapers and on advertisements published therein;

(*g*) Taxes on the sale and purchase of goods other than newspapers where such sale or purchase takes place in the course of inter-State trade or commerce.

Of these seven entries estate duty is being levied by the Centre and divided amongst the States. A tax on railway fares was once introduced but was soon merged with the basic rail fares. Income tax is compulsorily shared with the States under Article 270 of the Constitution while sharing of Union excise duties is permitted by Article 272. Currently all basic Union excise duties excluding cesses levied under Special Acts and earmarked for special purposes are shared with the States The States also get the entire net proceeds of the Union excise duty on generation of electricity.

Non-tax revenue, like the tax revenue, is divided into two parts, namely, non-tax revenue of the States themselves and that received from the Centre by means of grants-in-aid of revenues. The non-tax revenue of the States consists of interest receipts, dividends and receipts from general services, social and community services and economic services.

Expenditure on revenue account consists of three portions, namely, developmental expenditure, non-developmental expenditure and compensation and assignments to local bodies. *Developmental expenditure* itself is divided into that on social and community services and on economic services. Social and community services include education, art and culture, medical and public health, and natural calamities etc. while economic services include forests, agriculture, soil conservation, dairy development, cooperation, power projects, roads and bridges, industries, irrigation, and multipurpose river valley projects. The *non-developmental expenditure* covers debt servicing and interest payments, administrative services (including police), pensions and the like. It also covers the maintenance of State organs and fiscal services like the cost of collection of taxes and duties.

Capital Account. Capital account covers the creation, acquisition and disposal of assets and their corresponding liabilities which are not on a continuous basis. Expenditure on such heads is not expected to be charged to revenue account which is basically meant for financing the routine activities of the State.

A major portion of capital receipts of the State Governments consists of loans from the Central Government. About half of these loans are for Plan schemes. The bulk of the Plan schemes (about 90%) are in the State sector, while the rest consist of Central

schemes or Centrally sponsored schemes. Non-plan loans comprise of the States' share of the collection of small savings, relief for natural calamities and the like.

Currently only about 12.1% of the States' capital reciepts consists of 'internal debt', namely, market loans and loans from other institutions like the Life Insurance Corporation, State Bank of India, National Agricultural Credit (Long-term Operations) Fund of the Reserve Bank of India, National Cooperative Development Corporation, etc. Another 11.6% or so of the capital receipts of the States come from recovery of loans and advances which the State Governments have advanced earlier to various parties like cooperative societies for different purposes. Provident Funds, Reserve Funds, Deposits and advances etc. contribute another 15% and the rest of the receipts come form miscellaneous sources.

Captial disbursements consist of capital outlay. discharge of internal debt, repayments of loans of the centre, loans and advances by the State Governments, and appropriations to Contingency Fund. Currently, capital outlay, is less than one half of the total captial disbursement and bulk of it goes to economic services. Of the non-developmental outlay, a major portion goes as loans and advances to third parties and another for repayment of loans to the Centre.

Financial Trends

General. Since 1951-52, the State finances have shown a rapid upward trend both in revenue and expenditure (see Table 24.1). On Revenue Account, the State had total receipts of Rs 296.4 crores in 1951-52 rising to Rs 13210.4 crores by 1979-80 (BE), or about 44.6 times the base figure. About the same has been the case with expenditure on revenue account which rose from Rs 392.6 crores in 1951-52 to Rs 11765.0 crores in 1979-80 (BE) or by about 30 times. The revenue account has more or less tended to balance over years in the sense that deficits in some years have been offset by surpluses in the others. Thus during the First Plan period, total revenue receipts amounted to Rs 2335.4 crores against an expenditure of Rs 2396.7 crores. During the Second and Third Plans the revenue receipts exceeded the expenditure by Rs 106.6 crores and Rs 61.2 crores respectively. Similarly while during Annual Plans and the Fourth Plan period, there were deficits of Rs 45.8 crores and Rs 248.9 crores respectively, the Fifth Plan and 1979-80 showed surpluses of Rs 3140.5 crores and Rs 1445.4 crores respectively. On capital account, we find a similar mixed picture but with a definite and rapid increase in both receipts and disbursements. However, an important thing

to be noticed is the same mixed trend in overall balance in the State budgets as in the case with revenue account budgets, deficits have been larger and more frequent.

Revenue Account. Table 24.2 depicts the movements in the State revenue and its various components. We find that total revenue receipts have shown an impressive increase. From Rs 2335.4 crores during the First Plan, they rose to Rs 7129.9 crores for the three Annual Plans and then shot up to Rs 20930.2 crores and Rs 33337.6 crores for the Fourth Plan and Fifth Plan respectively. For the year 1979-80 (BE), they were Rs 13210.4 crores. But this rapid upward movement in State revenue does not mean that the State finances are in a comfortable position.The States' own revenue has not increased as rapidly and their dependence upon resource transfers from the Centre is much larger both in tax and non-tax revenues. Thus State's own tax revenue in the total tax revenue declined form 78.6% in the First Plan to 72.6% in the Annual Plans and during the Fifth Plan fell further to 70%. In 1979-80, it was 60.1%. Thus though in absolute terms the States' own tax revenue increased from 1264.7 crores in the First Plan to Rs 14761.5 crores in the Fifth Plan and to Rs 5285.2 crores for the single year 1979-80 (BE), in proportionate terms it lagged behind. The States' share from the Central taxes, on the other hand, increased both in absolute and in proportionate terms. They were only Rs 344.9 crores (21.4% of the total tax revenue) in the First Plan, but increased to Rs 4448.2 crores (or 33.4% of the total tax revenue) in the Fourth Plan. After that it was settling around 30% but the figure went up in 1979-80 due to the recommendations of the Seventh Finance Commission. These figures point out that either the States are not exploiting their tax resources to the full, or they are saddled with those taxes which have relatively low buoyancy and elasticity. If we look at the tax structure of the States a bit more closely, we find that those taxes from which the yield is not increasing rapidly admit of various changes. These taxes are not designed to reflect increasing activity through larger yield, and the States have not revised these tax rates adequately, and often enough. By a proper redesigning of these taxes, and choosing a rational method of imposing these taxes, they could be made to yield more as do the other taxes. For example, take the case of land revenue. The liability of land tax is not directly related to the productivity or value of land. As a result, land revenue has increased only marginally. From Rs 326.7 crores in the First Plan, it rose to only Rs 732 crorses in the Fifth Plan. On the other hand, stamps and registration, being *ad valorem*, have shown an upward trend with rising prices. From Rs 135.4 crores

TABLE 24.1

STATE BUDGETS—OVERALL BALANCES

(Rs in crores)

	First Plan	Second Plan	Third Plan	Annual Plans	Fourth Plan	Fifth Plan	1978-79 (RE)	1979-80 (BE)
Revenue Account								
Receipts	2335.4	4041.2	7332.9	7129.9	20932.2	33337.6	11444.4	13210.4
Expenditure	2396.7	3934.6	7271.7	7175.7	21181.1	30197.1	10676.5	11765.0
Surplus or Deficit	−61.3	+106.6	+61.2	−45.8	−248.9	+3140.5	+767.9	+1445.0
Capital Account								
Receipts	1114.5	2241.9	4690.1	4165.1	10722.9	11082.2	4599.3	3605.6
Disbursements	1063.9	2371.7	4689.1	4206.1	10551.4	14419.9	5225.6	5181.8
Surplus or Deficit	+ 50.6	−129.8	+1.0	−41.0	+171.8	−3337.7	−626.4	−1576.2
Overall Surplus or Deficit	−10.7	−23.2	+62.2	−86.8	−88.1	−197.2	+141.6	−130.8

Source: Various Issues of RBI Bulletins.

in the First Plan, it rose to Rs 905.8 crores during the Fifth Plan and even for the single year 1979-80, the figure (Rs 333.2 crores), was larger than what it was for the whole First Plan. Similar trends are noticed in sales tax, State excise, electricity duties, entertainment tax, and motor vehicles tax, etc. At the same time, like agricultural income tax, urban immovable property tax and the like have also not been fully exploited by the States.

Relatively speaking, the States' share in Central taxes has increased quite rapidly in absolute terms (and also as a proportion of their total tax revenue). Thus though in absolute terms estate duty is a small item, the State revenue from it increased by over 15 times form the first to the Fifth Plan. The states' absolue share from income tax increased ninefold during the same period and that from the Union excise duties by nearly 57 times. The performance of income tax, it is claimed, also would have been much better but for the fact that corporation tax is not shared with the States and because, since 1959, income tax law was changed to the disadvantage of the States. These shared taxes reflect the increasing tempo of economic activity as also the effect of increasing prices and therefore the yield from them has been rising quite fast.

All told a noticeable feature is that tax revenue as a proportion of the total State revenue has not changed much. It has hovered around 60-65%.

Similarly, when we look at the non-tax revenue of States, we find that here also their dependence has increased upon resource-transfers from the Centre, which mainly consist of grants-in-aid of revenues. Such grants have not only been increasing in absolute terms, but also as a percentage of the total non-tax revenue of the States. Thus during the First Plan, the States' own non-tax revenue was 74.2% of their total non-tax revenue (the balance 25.8% comprising grants and other contributions from the Centre); but there has been a steady downward trend in it and now States' own non-tax revenue is about half of the total. The non-tax revenue of States comprises of interest receipts, dividends, and receipts from general services, social and community services and economic services. It is, however, a patent fact that the State enterprises do not operate at a high-efficiency level. The Sixth and Seventh Finance Commissions had an occasion to extensively comment on the working of these enterprises. Most of these enterprises are not able to provide for the depreciation, interest charges and in some cases even the running expenses. Electricity schemes, irrgation (Commercial) and the like have shown either very marginal surplus or net losses.

It is claimed in certain quarters that the system of determining the grants-in-aid of revenus to the States has not worked towards stimulation of a revenue effort. The grants-in aid, as determined under the recommendations of the Finance Commission, are meant to help the States overcome their revenue gaps. This being so, there is not much incentive left for the States to observe a high degree of financial discipline and economy in their expenditure. Any success in economising State expenditure or increasing revenue (tax or non-tax) is likely to result in reduced grants-in-aid. It is far easier to plan for an increased expenditure than to implement a programme of increased revenue and the fact that the revenue gap is more or less assured to be bridged by revenue grants from the Centre militates against many decisions which are justified on fiscal grounds.

Coming to the State expenditure on revenue account we note a rapid rise in it. From a total expenditure of Rs 2396.7 crores for the full First Plan, it rose to 117650.0 crores for the single year 1979-80 (see Table 24.3). For the Fiftn Plan it totalled Rs 30197.2. crores. In other words, from the First to the Fifth Plan the total expenditure of States on revenue account rose by about thirteen times. If we divide the revenue expenditure into developmental and non-developmental ones, we note that with the passage of time, the relative importance of developmental expenditure has been increasing. Thus in the First Plan, developmental expenditure was only marginally greater than the non-developmental one. But in 1979-80 (BE), it was more than twice as much as the non-developmental expenditrue. Developmental expenditure includes education, medical and public health, civil works, agriculture, veterinary services and cooperation, rural and community development projects, water supply and family planning, and the like. Non-developmental expenditure, on the other hand, covers the cost of collection of taxes and duties, debt services and civil administration. Within the developmental expenditure, the main components have shown a more or less even increase excepting civil works and the head 'agriculture, veterinary services and cooperation.' In their case, we find that the increase is somewhat slower. On the non-developmental side, it will be found that the cost of collection of taxes and duties has come down as a percentage of the taxes and duties collected. From a figure of Rs 182.1 crores for the First Plan, expenditure under this head went up to approximately Rs 1439 crores for the Fifth Plan, while the revenue collected by the States on their own increased from Rs 1802.9 crores to Rs 21384.4 crores during the same period. The cost of collection therefore declined from 10.1% to 6.7% of the

TABLE 24.2

REVENUE RECEIPTS OF STATE GOVERNMENTS

(*Rs in crores*)

	First Plan	*Second Plan*	*Third Plan*	*Annual Plans*	*Fourth Plan*	*Fifth Plan*	*1978-79 RE*	*1979-80 BE*
Total Revenue (I+II)	2335.4	4041.2	7332.9	7129 9	20930.2	33337.6	11444.4	13210.4
I. Total Tax Revenue (A+B)	1609.6	2607.0	4535.9	4471.5	13357.4	21089.0	6760.0	8787.7
% of Total Revenue	68.9	64.5	61.9	62.7	63.9	63.3	59.1	66.5
A. States' Own Tax Revenue	1264.7	1936 1	3361.1	3207.8	8909.2	14761.5	4779.0	5285.2
% of Total Tax Revenue	78.6	74.2	74.1	72.6	66 6	70.0	70.7	60.1
of which								
1. Land Revenue	326.7	455.0	570.3	296 2	566.1	731.6	174.1	181.2
2. Stamps and Registration	135.4	183 9	302.7	280.5	968.2	905.8	300.3	333.2
3. State Excise Duties	230.0	242.0	375.3	398.5	1234.1	1875.1	564.8	570.1
4. Sales Tax	337.0	634.2	1344.8	1524.9	4357.7	8210.0	2696.9	3004.8
5. Electricity Duties	22.6	48 9	130.5	146.4	356.8	476 4	183.8	210.9
6. Entertainment Tax	31.9	52.3	110.4	100.73	346.9	634.7	200.3	220.7
7 Motor Vehicles Tax	65 1	124.7	265.1	233.3	586.3	876.6	300.0	357.5
8. Tax on Passengers and Goods	—	—	—	84.1	409.5	501.5	218.6	237.0
B. Shared Tax	344 9	670.9	1174.8	1264.9	4448.2	6327.5	1981.0	3502.5
% of Total Tax Revenue	21.4	25.8	25.9	27.4	33.4	30.0	29.3	39.9
of which								
1. Income Tax	277.9	377.2	554.6	507.9	2224.1	2603.1	730.5	851.0
2. Union Excise Duties	64.6	280.9	614.6	740.4	2384.6	3687.5	1240.5	2642.0
3. Estate Duty	2 4	12.8	25.6	16.6	39.5	36.9	10.0	9.5
II Total Non-Tax Revenue (C+D)	725.8	1434 2	2797.0	2659 2	7572.8	12248 6	4684.4	4422.7
% of Total Revenue	31.1	35.5	38 1	37.3	36.1	36.7	40.9	33 5

C. States' Own Non-Tax Revenue	538.2	1009.7	1564.1	1315.1	3759.7	6622.9	2208.8	2388.4
% of Tax Revenue	33.4	38.8	34.5	29.4	28.1	31.4	32.7	27.2
% of Non-Tax Revenue	74.2	70.4	55.9	49.5	49.6	50.8	47.2	54.0
D. Grants-in-Aid and other Contributions	187.6	424.5	1232.9	1344.1	3813.1	5625.7	2475.6	2034.3
% of Non-Tax Revenue	25.8	29.6	44.1	52.0	50.4	49.2	52.8	46.0
III. States' Own Revenue (A+C)	1802.9	2945.8	4925.2	4522.9	12458.9	21384.4	6987.8	7673.6
% of total Revenue	77.2	72.9	67.2	63.4	59.5	64.1	61.1	58.1

Source: Various issues of *RBI Bulletin*

TABLE 24 3

STATE BUDGETS – EXPENDITURE ON REVENUE ACCOUNT

Part A

(*Rs' in crores*)

	First Plan	*Second Plan*	*Third Plan*	*Annual Plans*	*1960-70*	*1970-71*	*1971-72*
I. Developmental Expenditure	1252.9	2212.8	4194.3	3445.7	1629.7	1844.2	2155.7
of which							
Education	394.5	757.3	1456 6	1177.9	680.4	793.4	886.5
Medical and Public Health	179.4	305.8	595.9	585.4	274.4	290.1	354.7
Civil Works	255.3	272.1	498.2	451.8	190.4	216.9	266.6
Agriculture, Veterinary Services and Cooperation	157.3	264.9	537.4	548.3	210.3	226.3	266.7
Rural and Community Development Projects	47.5	193.4	344.6	174.4	71.3	82.6	115.8
II Non-Developmental Expenditure**	1143.8	1721.8	3077.4	3155.2	1471.7	1545.7	1882.9
of which							
Collection of Taxes and Duties	182.1	286.4	337.5	310.2	129.5	147.8	168.2
Debt Services	64.4	275.0	926.6	942.4	369.9	398.1	455.8
Civil Administration	561.4	736.0	1105.4	990.0	410.6	455.1	508.0
Total Expenditure (I+II)	2396.7	3934.6	7271.7	7175.7	3101.4	3389.9	4038.6

Part B

	1972-73	*1973-74*	*Fifth Plan 1974-78*	*1978-79 (RE)*	*1979-80 (BE)*
I. Developmental Expenditure	3349.5	3812.5	20492.6	7430.3	8253.6
of which					
Social and Community Services	2079.3	2397.7	11993.7	4192.0	4631.5
Economic Services	1270.2	1414.8	8498.9	3238.3	3622.1
II. Non-Developmental Expenditure	1582.2	1853.8	9357.3	3111.7	3348.8
of which					
Collection of Taxes and Duties	173.3*	178.4*	1438.8	479.0	516 8

Debt Services and Interest Payments	693.8	835.7	3410.9	657.8	1172.8
Civil Administration	552.0	596.0	3412.2	1108.5	1220.4
III. Compensation and Assignments to Local Bodies	50.2	58.3	347.3	134.5	162.6
Total Expenditure (I+II+III)	4981.9	5724.6	30197.2	10676.5	11765.0

*Estimated.

**Include Compensation and Assignments to Local Bodies.

Source: Various issues of *RBI Bulletin* and Report on *Currency and Finance*

revenue collected. In recent years the States are finding expenses on this and similar items increasing due to rising prices and sanctioning of more salaries and allowances. In the same way, though expenditure on civil administration increased quite rapidly (about five times) it did not rise as fast as the total expenditure on revenue account. The bulk of the increase in this non-developmental expenditure was accounted by debt services, which jumped from a mere Rs 64.4 crores in the First Plan to Rs 3410.9 crores in the Fifth. Even for the single year 1979-80, the expenditure (Rs 1172.8 crores) on debt services was 16 times the one during the whole of First Plan (Rs 64.4 crores). Most of the expenditure on debt services is accounted by the indebtedness of the States to the Centre. Expenditure under this head would have been far larger but for the debt relief granted to States by the Centre under recommendations of the Sixth and Seventh Finance Commissions.

Capital Account: On account of the factors similar to those operateing on the revenue side, State budgets have shown a rapid increase on capital account also. The States are assuming, in an ever increasing measure, the developmental responsibilities of the economy and are trying to provide the social services needed for a rapid economic growth. Capital receipts of the States include borrowings from the market which form a major portion of the 'internal debt' of the States. But as a proportion of the total capital receipts the lion's share is claimed by loans from the Central Government. We have seen in Chapter on public debt in India that the Central Government helps the States for their Plan Schemes on a loans-cum-grants basis. For Centrally approved Plan schemes, the Centre gives aid of which 70% goes in the form of loans and the remaining 30% in the form of discretionary grants. For North-Eastern States, Jammu and Kashmir, and expenditure on certain hill districts 90% of the aid is in the form of grants and 10% in the form of loans. Theoretically,

the system of financing capital outlay through loans (which may be obtained from the Central Government) looks all right since ordinarily such loans are expected to be utilized for productive outlays. In due course, these outlays are expected to pay for themselves without causing any burden upon the State Governments. In practice, however, this argument overlooks some disturbing facts.

Firstly, not all investments are expected to be of commercial nature and capable of yielding adequate returns for the exchequer. A part of the capital outlay (though a small one) of the States does go into non-developmental items also.

Secondly, it so happens that many capital outlays of even commercial nature do not yield an adequate surplus. In many cases they end up with losses. The loans, therefore, become a deadweight partly on account of the type of investment and partly on account of inefficiency of various States concerns.

Thirdly, in the division of the State finances between revenue and capital accounts, interest and dividend receipts from various investments are shown on the revenue side. This means that the commercial capital outlays should yield enough surplus not only to meet the interest and dividend liabilities but also to provide a surplus for the repayment of the loans. These schemes are obviously not able to yield so much surplus. As a result, a major part of the fresh loans from the Centre is used to repay the maturing loans contracted earlier. As table 24.4 shows, the recovery of loans and advances has throughout been smaller than the repayment of loans to the Centre. This excess has been there even after the debt relief extended on the recommendations of the Sixth Finance Commission and the

TABLE 24.4

SOME LOAN TRANSACTIONS OF STATES

(*Rs in crores*)

	1972-73	*1973-74*	*Fifth Plan*	*1978-79*	*1979-80*
Receipts	2132.5* (1711.4)	1787.8	7251.1	3455.8	2540.0
1. Loans from the Centre	1950.2*	1552.9	5805.6	3084.8	2122.4
2. Recovery of Loans and Advances	182.3	294.9	1445.5	371.0	417.6
Disbursements	1410.4	1537.3	7589.4	2624.7	2363.7

3. Repayment of Loans to the Centre	689.6	933.9	2792.9	794.7	604 7
4. Excess of (3) over (2)	507.3	699.0	1347.4	423.7	187.1
5. Loans and Advances to Third Parties	720 8	603.4	4796.5	1829.9	1759 0
Excess of Receipts over Disbursements (1 +2—3—5)	722.1* (301.0)	250.5	—338.3	831 2	176.2

*Including Rs 421.1 crores to clear overdrafts from the Reserve Bank of India.
Source: *RBI Bulletin*, various issues.

picture has not changed even with the relief granted under recommendations of the Seventh Finance Commission.

TABLE 24.5

STATE BUDGETS—RECEIPTS ON CAPITAL ACCOUNT

Part A

(*Rs in crores*)

	First Plan	*Second Plan*	*Third Plan*	*Annual Plans*	*Fourth Plan*	*1974-75 (BE)*
Permanent Debt	157.9	337 4	442.9	352.6	905.7	265.1
Loans from the Centre	769.5	1417.0	3091.7	3039.2	6769.2* (6348.1)	1033 1
Unfunded Debt	26.9	49.9	100.4	128.8	445 6	106 6**
Others	160.2	437.6	1055.1	1043.8	2659.5	649 9
Total Capital Receipts	1114 5	2241.9	4690.1	4165.1	10780.0* (10358.9)	2053 0

Part B

	1972-73	*1973-74*	*Fifth Plan 1974-78*	*1978-79*	*1979-80*
A. Loans from the Centre	1950.2* (1529.1)	1552.9	5805.6	3084.8	2122.4
B. States' own Capital Receipts *of which*	924.8	930.3	5276.6	1514.5	1483.2
1. Internal Debt *of which*	261.7	220.8	1578.7	383.1	436.1
Market Loans	215.6	166.2	1152 4	280.1	340.7

2. Recovery of Loans and Advances	182.3	234.9	1445.5	371.0	417.6
3. Small Savings, PF, etc. (net)	100.6	130.7	738.4	284.5	292 2
4. Inter-State Debt Settlement (net)	1.3	− 0.1	+53.4	0.4	—2.6
5. Contingency Fund (net)	31.7	—0.5	+164.1	+27.2	4.8
6. Reserve Fund (net)	152·4	277.6†	508.2	175.8	126.7
7. Deposits and Advances (net)	78.5	104.5††	380.9	170.4	126.1
8. Suspense and Miscellaneous (net)	116.3	—37.6††	430.9	82.3	101.9
Total Capital Receipts	2875.0*	2483.2	11082.2	4599.3	3605.6

*Includes Ways and Means Assistance from the Centre for clearing overdrafts from the RBI.

**Compiled from Report on Currency and Finance, 1973-74.

†Includes entries (7) and (8) for Tamil Nadu.

††Excludes Tamil Nadu.

Source: Various issues of *RBI Bulletin*.

Other items on the receipts side of capital account include, in addition to the recovery of loans and advances, small savings and provident funds etc. The States get a share of the small savings collections by way of loans. Some receipts are also there by way of 'deposits and advances,' reserve funds, inter-State settlements, appropriations from Contingency Fund, and suspense and miscellaneous items.

Capital disbursements of the States may be divided into capital outlay and the rest of the items. As Table 24.6 shows, capital disbursements increased to fourteen times from the First to the Fifth Plan and for the year 1979-80 (BE) itself, they were nearly five times the First Plan figure. An unmistakable feature here is the reduced proportion of capital outlay and a corresponding proportionate increase in disbursements under other categories up to Fourth Plan. Since then, however, this proportion has increased again. Thus, during the First Plan, capital outlay formed 63.0% of the total capital disbursements; the figure dropped to 56.5%, 41.1%, and 33.3% respectively during the Second, Third and Annual Plans res-

TABLE 24 6

STATE BUDGETS—DISBURSEMENTS ON CAPITAL ACCOUNT

(*Rs in crores*)

	First Plan	*Second Plan*	*Third Plan*	*Annual Plans*	*Fourth Plan*	*Fifth Plan*	*1978-79*	*1979-80*
I. Capital Outlay	670.4	1340.7	1928.5	1398.9	3460.1	6053.4	2457.8	2646.6
% of Total Disbursements	63.0	56 5	41.1	33.3	32.8	42 7	47.0	51.1
of which								
(*i*) Development Outlay	698.8	1260.0	1800.4	1362.7	3434.6	5940.2	2410.0	2577.0
(*ii*) Non-Developmental Outlay	—28.4	80.7	128.1	36.2	—1.4	113.3	47.8	69.6
II. Discharge of Internal Debt	29.8	50.1	121.1	133.2	384.4	463.4	142.6	175.3
% of Total Disbursements	2.8	2.1	2.6	3.2	3.6	3.7	2.7	3.4
III. Repayment of Loans to the Centre	72.1	365.2	1014.2	1217.3	3666.6	2792.9	794.7	604.7
% of Total Disbursements	6.8	15.4	21.6	28.9	34.7	19.7	15.2	11.7
IV. Loans and Advances to Third Parties	291.6	610.0	1581.4	1356.8	2801.7	4796.5	1829.9	1759.0
% of the Total Disbursements	27.4	25.7	33.7	32.2	26.6	33.8	35.0	33.9
V. Repayments of Other Loans etc.	—	5.7	43.9	100.0	238.6	185.8	0.1	—0.1
% of Total Disbursements	—	0.4	0.9	2.4	2.3	1.3	0.6	—3.8
Total Disbursements	1063 9	2371 7	4689.1	4206.1	10551.4	14191.9	5225.6	5181.8

Source: Various issues of RBI Bulletin.

pectively. During the Fourth Plan there was a slight increase after 1972-73 and the figure averaged 32.8% while for the Fifth Plan 1978-79 and 1979-80, the figures were 42.7, 47.0 and 51.1 respectively. However,barring a small amount, almost the entire capital outlay goes into developmental schemes.

The discharge of internal debt accounts for a small percentage of the total capital outlay, mainly because the States rely upon market borrowings only to a limited extent. Their major source of borrowings is the Central Government and it is found that the repayment of Central loans has increased both in absolute and proportionate terms, except during the Fifth Plan period and later. This is due to debt relief granted under recommendations of the Sixth and Seventh Finance Commissions. Loans and advances to third parties have shown an absolute increase year after year though as a percentage of total capital disbursements the figure has been varying. All told, therefore, one may conclude that in the upward movement of different components of capital disbursements, the repayment of loans to the Central Government seems to have increased at the cost of developmental capital outlay.

Some Comments

Our Constitution has favoured a financially strong Central Government and the division of financial powers is designed in such a way that the State Governments become dependent upon resource transfers from the Centre. These constitutional provisions have in practice been used in such a way as to necessitate sizeable transfer from the Centre (in the form of sharing of taxes, grants-in-aid and loans) and increase the States' indebtedness to the Centre. The whole approach has certain drawbacks from the point of view of States.

Firstly, the resources transferred by way of tax-sharing are limited. As seen above, the Centre imposes only estate duty out of the taxes mentioned in seven entries in Article 269. The other taxes have not been exploited for the benefit of the States. Even the tax on railway passenger fares was merged with the basic railway fares and the States are given a fixed grant in lieu of that. As regards sharing the proceeds of other taxes with the States, the approval adopted by the Finance Commission seldom left any manoeuvrability for them. The percentage share of excise duties recommended for the States tended to be decided on this principle. The Finance Commission, while making its recommendations, would generally try to balance the increasing needs of the States with the possible increase in their absolute

share from the excise duties. The recommendations of the Finance Commission cover a period of five years or so during which the Central Government would be imposing fresh duties on new articles out of which the States would not be entitled to get a share. This defect was removed only with the recommendations of the Fourth Finance Commission according to which the duties to be imposed during the coming five years were also to be shared with the States on the same principles as the exisiting ones. The auxiliary duties were made shareable only under the recommendations of the Sixth Finance Commission from 1976-77 onwards. As a consequence they were merged with the basic duties. But the Central Government has repeatedly resorted to levying of new excise duties under new terminology and thereby avoiding the sharing of proceeds with the States. Even in 1978-79, the Centre imposed a special duty at the rate of 5% of the basic duties. (The proceeds of special duties were not to be shared with the States). Further, even then the share of the states remained only 20% of the net proceeds (it was raised to 40% by the Seventh Finance Commission) and the surcharges, cesses, etc. levied specifically for the purposes of the Union are not shareable. In the case of income tax, however, the position is much better. The States' share has gradually been increasing and now stands at 85% of the net proceeds.

Moreover, successive Finance Commissions were subjecting the State forecasts to itemwise scrutiny and systematically underestimating their projected expenses and overestimating their projected receipts. The Centre's projections were not put to any scrutiny. The Seventh Finance Commission took some remedial steps here. It subjected the Centre's projections also to a close scrutiny, and it did allow some additional expenses by the States. It recognized the additional needs of the States and enhanced their share in Union Excise Duties from 20 to 40% and that of income tax from 80 to 85%. But it did not provide a consideration for the fiscal discipline and prudence by the State. Also (as in the past), grants-in-aid did not provide for a variation in prices. The Centre was quick to react to the recommendations by enhancing the surcharges on income tax and corporation tax (though surcharges are supposed to be only temporary levies). It may be noted that in terms of our Constitutional provisions and the working of economic laws, the resource transfers from the Centre to States (both in absolute terms and as a proportion of the Centre's resources) should keep on increasing. The recommendations of the

Seventh Finance Commission do not make a major break with the past in terms of the said proportion.

Secondly, the institution of the Finance Commission was created to impart a flexibility in the Centre-State financial transfers such that the needs of the changing situation could be taken into account and required adjustments made. The actual working of the Finance Commission has tended to limit the devolution of such resources only to meet the minimum need gaps of the States together with an element of uncertainty as to what the future Finance Commission might recommend. The shares of the States vis-a-vis each other are subject to all kinds of uncertainty and variation. Different Finance Commissions have adopted different criteria in this regard. Similarly, when it comes to statutory grants under article 275, we find that they are meant only for meeting the revenue gaps of the State. A State which through its financial prudence and efficiency at mobilisation of revenue resources finds its revenue budget balanced or in a surplus, loses a part or all of the statutory grants, while the States which are less economical and financially disciplined receive them in larger amounts. In other words, through shared taxes and statutory grants, a State cannot hope to end with a surplus revenue budget. If the revenue budget is to show a surplus, it is expected to do by having an excess of revenue (excluding grants) over its expenditure on revenue account. In view of these circumstances, there have been suggestions that the States' shares should be constitutionally fixed so as to enable each State to develop and derive benefit out of its own revenue resources.

Thirdly, under the present system of resource transfers from the Centre, the States are pushed into indebtedness in spite of adequate financial discipline and tax effort. As we have seen, the whole system of tax-sharing cum grants on revenue account tends to disable the States from developing a revenue surplus for use on capital account. The gap in the capital budget has to be met by aid from the Centre. And such a gap is often substantial because of limited market borrowings by the States on the one hand and extra disbursements due to the previous indebtedness to the Centre on the other. The aid from the Centre is mostly in the form of loans under Article 293 and partly as grants under Article 282. Increasing indebtedness of the States to the Centre reduces their manoeuvrability and increases the fixed-cost items in their expenditure commitments.

We should not come to the conclusion that the States are always doing their best in resource mobilisation or that they are saddled with

only inelastic and non-buoyant resources. Such a view can be debated. On the one hand it goes without saying that the needs of the States are mounting fast since quite a large portion of public services have to be provided by the States and their commitments along economic, social and others lines are increasing fast. On the other, the revenue heads available to the States are also limited. But there are two arguments which can be put forth to support the view that the States are not as badly placed as is given out. The first is that the States have not cared to tap all the available resources to an optimum level. An important case in point is agriculture. (We shall be dealing with the problem of agricultural taxation in a separate chapter). Agriculture can yield public revenue in various forms like a tax on agricultural incomes, a tax on agricultural holdings, irrigation and water rates, betterment levies, cesses on commercial crops, land revenue and the like. Most of these resources remain untapped or only partially exploited by the States. The second argument is that there are some taxes which have a natural buoyancy and are also sufficiently elastic. For example, sales tax, even with given rates, would yield greater revenue as economic activity increases. And quite a good deal of scope to increase sales tax revenue exists through covering more items and raising existing rates. In 1951-52, the yield from sales tax was Rs 58.9 crores out of the total State revenue of Rs 396.4 crores. As a proportion of the State revenue, sales tax formed 14.9%. By 1979-80 (BE), sales tax revenue had increased to Rs 2934.6 crores against the total revenve of Rs 12805.7 crores, that is 22.9% of the total revenue. It was not only an absolute but a proportionate increase also. As a proportion of the tax revenue of States, sales tax increased from 21% in 1951-52 to 57.8% in 1979-80 (BE). A similar picture is presented when we consider the State excise, or electricity duties. It can also be seen that if the structure of land revenue is changed (for example in terms of Agricultural Holdings Tax), it would become quite buoyant.

An important potential source of revenue for the States is the agricultural sector. It contributes over 40% of our national income, but is relatively lightly taxed. Various arguments have been put forth to show this fact such as by showing that as a proportion of income, agricultural taxation is lower than it is in other sectors. Of various components, it is found that some States do not impose agricultural income tax and total yield from this tax is quite small. Land revenue proper is not directly related to agricultural productivity and therefore lacks natural buoyancy of a good tax. There are also various defects in land records etc. and that makes land revenue a still lesser impor-

tant revenue source. Moreover, taxation of agricultural income, being a State subject, and being exempt in a number of States, used to provide a good avenue for evasion of income tax on non-agricultural incomes (incomes from non-agricultural sources were being shown as incomes from agriculture). Raj Committee came out with recommendation of a partial integration of agricultural with non-agricultural income (*see* the chapter on agricultural taxation for details). The acceptance of this suggestion is an important though incomplete step towards checking tax evasion of non-agricultural incomes. Raj Committee also recommended the imposition of Agricultural Holdings Tax in replacement of land revenue. AHT is designed to reflect agricultural productivity with reference to soil fertility and crops sown. However, States have not been enthusiastic about the scheme. They have either shunned it, or significantly modified it. For example, Haryana imposed Land Holdings Tax in 1973-74, and Himachal Pradesh introduced an Agricultural Holdings Tax in 1974-75. But Himachal Pradesh imposed it on holdings in excess of 20 rateable acres in size and expected a revenue of only Rs 35 lakhs. Maharashtra has gone in for an *ad hoc* tax which is levying a holding surcharge based on: (*a*) land revenues and local cesses, and (*b*) education cess on agriculturists.

It is very clear that States can and should exploit agricultural taxation on an extensive scale. During the last few years, agricultural prices have shifted the terms of trade in favour of agriculture and the paying capacity of agriculture has increased. The whole system of agricultural taxation, of course, should be progressive in structure whereby the marginal farmers are not unduly burdened Apart from imposing agricultural income tax and AHT, the States should also take pains to collect betterment levies, and rationalise water rates for irrigation. Irrigation schemes are generally showing commercial losses. Selective taxation of various other inputs like electric pumps and fertilizers can be used. Moreover, there are wide variations in land taxation systems between different States. To the extent possible, such differences should be wiped out.

States cannot impose income tax on non-agricultural income. But they can impose a profession tax under Article 276 of the Constitution. The profession tax is a tax on professions, employments and callings. But the tax liability can be related to and can amount to a tax on income from such professions, callings or employments. However, the maximum amount of profession tax that can be levied on any one person cannot exceed Rs 250 p.a. and persons not liable to pay income tax are exempted. It may, however, be mentioned

that this tax is discriminatory since it is not based upon tax-paying capacity irrespective of the source of income. For example, recipients of unearned incomes (who should ordinarily be taxed more heavily) do not come under this tax liability. It is therefore discriminatory in favour of propertied classes. At present, however, profession tax yields only a small amount of revenue to the States.

Stamp duties and registration are assuming an increasing importance in State revenues because of rising prices of the properties and increasing economic activities necessitating documentary evidence. A stamp duty is a tax on a documentary evidence of particular transaction/transactions, such as transfer of property, loans, bonds mortgages, debentures, bills of exchange, promissory notes, and the like. It must be remembered, however, that it is the evidence and not the transaction itself which is taxed. If a transaction takes place without creation of a documentary evidence (such as a loan) then no stamp duty is levied thereon. Stamp duty is determined on an *ad valorem* basis, the value of the transaction being the base for calculation of the duty. However, it is usual to provide for certain exemptions in order to facilitate those transactions which for various reasons are considered essential but where the stamp duty would prove unduly burdensome or will violate certain chosen objectives of economic and social policy.

If the documents are also sought to be registered, then in certain cases, a requisite registration fee has also to be paid. Registration fee is generally *ad valorem*, but the schedule of rates may vary for different types of transactions and documents. Revenue from Stamps and Registration has been steadily increasing.

A complicated but very important source of state revenue is the sales tax. In India, sales tax is of recent origin. It was first introduced by C.P. and Berar in the form of a 5% tax on the retail sales of motor-spirit and lubricants in 1938. Currently all the States are imposing sales tax in various forms and on various items. The States are basically allowed to levy sales tax only within their jurisdiction (excepting newspapers and the advertisements therein) but not on inter-State trade and commerce or foreign trade. Whether or not a particular transaction is inter-State is decided under the Central Sales Tax Act. Since 1956, the Central Government imposes a sales tax on inter-State trade and commerce. Central sales tax was at the rate of 3% till 30 June 1975 and was raised to 4% with effect from 1 July 1975. The Central Sales Tax applies to all sales of goods except newspapers. The proceeds of this Central sales tax are assigned to the States. Further-

more, on a few commodities of special importance which are declared "essential" under Sections 14 and 15 of the Central Sales Tax Act, the Central Government imposes additional duties of excise in lieu of the sales tax and the net proceeds of such duties go to the States. As between the States, however, the sales tax structure is not uniform, and its actual administration leaves a good margin for tax evasion. There are numerous exemptions, deductions, rate differentials and the like. Different sales taxes are collected at different points depending upon who the last purchaser is with 'sales tax number.' Moreover, not every shopkeeper is given a 'sales tax number' which divides the sales at the wholesale level into those paying sales tax and those not paying sales tax. Because of the difficulties of bringing together the necessary information etc the tax administration becomes quite inconvenient and complicated. It is, therefore, sometimes suggested that the sales tax should be imposed at the first point of sale.

However, over the years, sales tax has proved to be a very rich source of revenue to the States The yield from this tax automatically goes up as economic activity picks up. Additionally the States have extended the coverage of the tax and occasionally revised the rates upwards. This has, therefore, added further strength to this source. Sales tax is now the most important source of tax revenue for the States and exceeds the share of the States from all the Central taxes. From a yield of Rs 337.0 crores in the First Plan, it rose to Rs 634.2 crores in the Second Plan and Rs 1344.8 crores during the Third Plan. The Annual Plans yielded a revenue of Rs 1524.9 crores from sales tax, while in the Fourth Plan the yield was Rs 4357.7 crores. The figure for the Fifth Plan is Rs 8209.98 crores and for 1979 80, Rs 2934.6 crores. It was about 23% of the total revenue of the States and about 40% of the States' tax revenue. If we consider only the States' *own* tax revenue, sales tax is found to contribute more than half of this. On the basis of previous experience, sales tax appears to be the most promising future source of tax revenue for the States. A selective use of the sales tax with its proper administration is an effective economic instrument. It, however, is pro-inflationary since it raises the prices of consumption goods and materials coming under it. The taxing of various intermediate goods and inputs pushes up the cost of production. Another defect of sales tax is that since it is levied with an eye on revenue, it tends to be quite regressive. Though various luxury items pay sales tax at higher rates than other necessary goods, this rate differential is not able to rub away the regressiveness of the sales tax.

The importance of streamlining the administration of sales tax cannot be underestimated. This should reduce the sales tax evasion which is stated to be quite widespread. It will also impart still greater flexibility to this source of revenue and enable the States to raise their resources together with making this tax a more effective policy tool. Wherever it is feasible, sales tax should be levied on a single-point basis and there should be a harmony of rates and goods covered in the neighbouring States.

State excise duties can be levied on alcoholic liquors for human consumption and on opium, Indian hemp and other narcotics and drugs. But medicinal and toilet preparations containing alcohol, drugs and narcotics are exempted. The field of State excise is, therefore, quite a restricted one and compared with sales tax, the yield from excise duties has shown a limited increase. In the State tax structure, excise duties rank second to sales tax. This was however not the case throughout. During the first three Plans, revenue from State excise was lower than the land revenue. It was only during the Annual Plans that State excise exceeded land revenue. Partly, the reason for this state of affairs is the policy of prohibition. According to the Directive Principles of our Constitution, total prohibition is to be achieved in our country and 1968 was the target date for achieving this objective. During these years, different States have tried to adopt partial or total prohibition. In terms of tax finances, the prohibition is not helpful for the States. On the one hand, prohibition dries up an important source of tax revenue and on the other public expenditure increases on account of administering the policy. Currently excise duties on alcoholic drinks fetch a revenue of more than Rs 500 crores p.a. to the States. Prohibition has passed through various phases. One such phase was the recommendation of the Planning Commission's Committee on Prohibition that gradually the whole country should be covered by prohibition. As a result the Central Government offered to compensate the States by meeting 50% loss of revenue on account of prohibition. The offer was again renewed for five years in 1968. But the States have repeatedly realized that it is highly expensive to pursue this policy. Actually the opponents of prohibition argue that it not only causes a loss of revenue to the States, but imposes a great economic hardship on the poorer sections of the society. They are driven to the consumption of illicit and dangerous liquors and their substitutes at high prices at the cost of some other and more useful consumption. It is, therefore, argued by these people that it will be helpful, both to the States and to the public at large, if the policy of prohibition is not pursued and *cheap*

and safe liquors are provided to the public to satisfy their drinking needs. It, of course, does not mean that we should not go ahead with the programme of prohibition simply because it is not helpful for the public treasury. It only means that if the consumption of liquor is to be discouraged, it should be done through publicity and pursuasion.

Other important tax revenues include motor vehicles tax, electricity duties, entertainment tax and tax on passengers and goods. Regarding the motor vehicles tax, Parliament has the power to legislate about mechanically driven vehicles and the principles on which taxes are to be levied on such vehicles. But the quantum of such taxes is left to the discretion of the individual States. As a result, we have quite a good deal of variety in these taxes as between States. An electricity duty is either a tax on consumption of electricity or a surcharge on electricity tariff. But our Constitution provides some exemptions from this tax. Firstly, electricity consumed by Indian Railways and the Government of India is exempted. Secondly, a duty will not be levied upon the electricity generated, consumed distributed or sold by any authority established for regulating or developing any inter-State river or river valley without the consent of the President and a law by the State legislature. As the generation and consumption of electricity increases in the country, the yield from electricity duty will also increase. Taxation on passengers and goods was started during the Third Plan and now all States are levying this tax. The rates of this tax are not uniform as between different States.

The share of the States in Central taxes has increased in absolute terms. The increase has been the maximum in the case of Union excise duties. The yield from income tax has gone up both on account of a larger percentage share being assigned to the States and increasing yield from this tax. Their share from Union excise duties is mainly the result of widening the coverage of these duties, revision in their rates and consequently an increase in the tax yield. From 1979-80 onwards, the share of States has been raised from 20 to 40% of the net collections. Estate duty, however, brings in only a marginal amount.

In conclusion we must remember that State taxation and its administration needs a reorientation. The cost of collection of State revenues is too high; it is over 6% of the States' own tax revenue which indicates a high degree of inefficiency. Furthermore, at present the tax burden is relatively too high for non-agricultural population. Agricultural taxation must be restructured to yield larger revenue to the States on the one hand and bring about greater equality of sacri-

fice as between different sections of the population on the other. Efforts must also be made to streamline the tax administration and bring about a closer harmony and coordination between tax and rate structure as also between neighbouring States. This would not only reduce the difficulties faced by the tax-payers but would also enable the States to plug tax evasion and raise greater tax revenue without upward revision of tax rates.

25 AGRICULTURAL TAXATION IN INDIA

The term agricultural taxation covers numerous direct and indirect taxes. Direct taxes come within the purview of the State Governments while we have a mixed picture as regards indirect taxes. Direct taxes would include land revenue, agricultural income taxation, cesses and surcharges on agricultural crops, development levies and the like. Indirect taxes would cover the taxation of agricultural inputs like water, use of electric and diesel pumps, fertilizers, pesticides and other chemicals etc Here we find that the Central Government has the authority of imposing excise duties on items like fertilizers and pumps etc. but the State Governments can impose sales tax on them. Further, the irrigation and other developmental schemes are normally within the purview of the States so that the States can charge for their use in the form of water rates and the like.

It is claimed that for both historical and Constitutional reasons, agricultural taxation in India has come to lack uniformity and equity and has also become a medium of tax evasion on non-agricultural incomes. It is claimed that instead of taxing agricultural sector on par with non-agricultural sectors in the country, the States have shown a marked degree of favour to agriculture. Even the Central Government has been subsidizing various agricultural inputs (which help the richer farmers instead of the poorer ones) instead of tapping their tax potential.

Let us start with the question of uniformity.

Through historical evolution, agricultural taxation in India came to lack a uniformity not only between different States, but also between different regions of the same State. At the time of Independence, the British Provinces had different forms of land revenue assessment coupled with (in some casses) exemptions and remissions. The British had evolved zamindari, mahalwari and ryotwari systems. Furthermore, the land revenue did not reflect the relative productivity or fertility of different lands. Land development like irrigation had been more or less ignored in fixing the land revenue. A levy for the use of irrigation water was collected more in the form of a rate or a tax on the use of an input than to tax any resultant extra paying capacity of the farmer. Very few princely

states had an organized system of land revenue. Lands were not even surveyed and settled. The picture became all the more complicated when attempts at land reforms were made after Independence. Different States adopted different laws and there were variations in the degree of their implementation as well. In some cases legal difficulties were also encountered by attempts at bringing about uniformity. At the same time, financial needs of States prompted some of them to levy surcharges, betterment levies, and cesses based on land revenue or crops. These surcharges and cesses were also expected to introduce an element of progressiveness in land revenue. The picture gets further complicated when we note that in some States land development tax has been imposed. An important cause for lack of uniformity lies in the fact that in many cases the States have followed a different rate policy project-wise. Within a State, water rates vary on the basis of crops grown, the area of district and whether water is being supplied from an old or a new irrigation scheme. Rates are higher in the case of new schemes, but even then they are seldom able to cover the investment in the projects. As a rule, cash crops are subjected to higher water rates than other crops. All told, there are wide variations in rates within each State and still wider differences as between States This state of affairs not only indicates a lack of proper fiscal policy on the part of the State Governments, but also the fact of huge untapped resource potential.

Similarly, though agricultural income tax has a long history, some States impose agricultural income tax and others do not. The first distinction between agricultural and non-agricultural incomes was introduced in 1886 when agricultural income was excluded from the payment of Central income tax. This system continued till 1937 when the permission was granted to the Provincial Governments for levying a tax on agricultural incomes. The first province to levy this tax was Bihar (in 1938-39) followed by Assam (in 1939-40) and Bengal (in 1941). Even currently the main yield of agricultural income tax is in the case of States having plantations.

Rationalising Agricultural Taxation

Our Constitution has assigned the subject of agriculture to States as also the power to tax agricultural properties, agricultural income and agricultural production etc. However, for various reasons agricultural sector is believed to be taxed lightly as compared with non-agricultural sectors. Thus, a case for increasing the burden of taxation on agriculture rests on the grounds of: (*i*) equitable distribution of

taxation on agricultural and non-agricultural sectors: (*ii*) the need to raise additional resources, especially for the States; and (*iii*) checking tax evasion in non-agricultural sectors. In addition to the above, the tax structure in agricultural sector itself needs a remodelling so as to conform to various criteria of justice and efficiency. Let us look at the arguments for bringing agriculture under a heavier burden of tax.

The first argument put forth here is that a major portion of tax burden of developing our economy is being borne by non-agricutural sectors. In 1960-61, agriculture (including forestry, logging, fishing, mining and quarrying), contributed 52.5% of net national product (at 1960-61 prices); and though over subsequent years it showed a fall, still in 1977-78, it was 45.5.[1] And it is argued that it should bear a proportionate burden in the tax revenue of the government. Since agriculture is a State subject, it would be more meaningful to analyze the role of agricultural taxation in the State revenue. "Direct taxes on agriculture have so far taken the form mainly of land revenue, cesses and surcharges on land revenue, cesses on crops and agricultural income tax."[2] Table 25.1 shows tax revenue collected by

TABLE 25.1

DIRECT AGRICULTURAL TAXATION

(*Rs in crores*)

	1972-73	*1973-74*	*1974-75*	*1975-76*	*1976-77*	*1977-78*	*1978-79*	*1979-80*
Agricultural Income Tax	14.42	11.81	13.88	28.50	34.55	38.48	65.6	65.9
Land Revenue	92.93	157.01	160.51	229.70	183.04	158.32	174.1	181.2
Others*	21.23	21.70	30.98	35.40	48.45	51.66	44.7	44.0

*Covers Purchase Tax on sugarcane, surcharges and cess on sugarcane and surcharge on cash crops.

Source: *RBI Bulletin*, various issues.

States from these various direct taxes. It would be noted that land revenue forms the bulk of direct agricultural taxes. Agricultural income tax, on the other hand, contributes only marginally to the

[1]Economic Survey, 1978-79, p. 64

[2]Committee on Taxation of Agricultural Wealth and Income (Raj Committee), Government of India, Ministry of Finance, *Report*, October 1972, para 1 11.

State revenues. Table 25.2 shows that place of land revenue and agricultural income tax in the State revenues from 1951 onwards. Both land revenue and agricultural income tax have rapidly fallen as a proportion of the State taxes While land revenue formed an average of 25.9% in the First Plan during the Fifth Plan period it fell to only 5.0% and in the budgets for 1979-80 to just 3.4%. Similarly agricultural income tax, which was only 2.0% in the First Plan, fell still further during the Fifth Plan and was 1 2% in the budgets of 1979-80. The proportion of direct agricultural taxation in the State revenues differs from State to State And even as a percentage of national income from agriculture, direct taxes on agriculture have been quite low and steadily falling with a continuous increase in agricultural productivity and income According to Raj Committee land revenue and agricultural income tax as proportion of national income were only 1.63% in 1960-61 and steadily fell to

TABLE 25 2

LAND REVENUE AND AGRICULTURAL INCOME TAX IN STATE TAXATION

(Rs in crores)

	Land Revenue	*Agricultural Income Tax*	*Total Revenue from State Taxes*	*Land Revenue as % of Total Revenue from State Taxes*	*Agricultural Income Tax as % of Total Revenue from State Taxes*
1	2	3	4	5	6
First Plan Annual Average	65 34	4 82	251 42	25 9	2 0
Second Plan Annual Average	91.00	8.50	379 58	24 0	2 0
Third Plan Annual Average	114 06	9.78	667.98	17.0	1.4
Plan Holiday (Annual Plans)					
Annual Average	102.36	10.97	1074.44	9.6	1.1
Fourth Plan Annual					
Average (with 1973-74 BE)	113.22	12.35	1781.84	6.3	0 7
Fifth Plan Annual Average	182 88	28 86	3690.37	5.0	0 8
1978-79	174.1	65.6	4779 0	3.6	1.4
1979-80	181.2	65.9	5285 2	3.4	1.2

Source Dr P.K. Bhargava and G.S. Srivastva, "Taxing Farm Incomes. Neglected Possibilities," *Eastern Economist*, 21 June 1974, *RBI Bulletin*, various issues.

0.85% in 1970-71.[3] On the other hand, as Bhargava and Srivastva show, the percentage of direct taxes on non-agricultural sector was 3.4% of national income in the First Plan, 3.8% in the Second Plan and 5.4% in the Third Plan, where it was almost stabilized for the later years.[4] This indicates another aspect of the uneven tax burden on agricultural and non-agricultural sectors. The average rate of direct taxation on the agricultural sector, on the other hand, was 1.4% in First Plan, 1.6% in the Second Plan and 1.4% in the Third Plan. During the Annual Plans, it was 0.8% and fell to 0.7% for the year 1969-70.[5]

The unevenness of tax burden on agricultural and non-agricultural sectors is, however, not as sharp as is reflected from the above data. It so happens that a much larger population subsists on agriculture with the result that the average income level in agriculture is far lower than it is in non-agricultural sectors. Those who can be effectively taxed in agricultural sectors are relatively smaller in proportion to the agricultural population. It is also argued that with the imposition of ceilings on land holdings and increasing pressure of population on agriculture, it will lose its importance as a potential source of tax revenue. But still, though these phenomena indicate that we should not try to tax agriculture as heavily as other sectors, currently agriculture is taxed far more lightly than is warranted. In effect, land reforms towards implementation of land ceilings have not succeeded sufficiently. There are large-scale inequalities of income and wealth in the rural areas and such inequalities are increasing with the introduction of better inputs and improved methods of cultivation. Moveover, as Raj Committee states, evenness of tax burden may not be in terms of a tax revenue as a portion of sectoral income, but there should be a parity of taxation for similar incomes irrespective of their sources. As it is, agricultural taxation can always be devised in terms of progression so that if and when income of a family falls, its tax liability is accordingly reduced or abolished.

The second main reason for bringing agriculture in the tax net is the fact that the Government needs huge resources for developmental effort. Agriculture is the biggest contributor to our national income and is naturally expected to contribute its share in raising the necessary resources for economic development. Like industrial and

[3] *Op. cit.*, p. 8

Dr P.K. Bhargava and G.S. Srivastva, "Taxing Farm Incomes: Neglected Possibilities," *Eastern Economist*, 21 June 1974, pp. 1209-1211.

[5] *Ibid.*

services sectors, agricultural sector should also yield an economic surplus in order to accelerate the pace of capital accumulation and economic growth. If surpluses generated in non-agricultural sectors have to be diverted towards agriculture while a major portion of the potential surplus in agriculture goes to wasteful consumption, the economy as a whole loses. It is important that all the potential sources of economic surplus must be effectively tapped and the resources so collected should be used judiciously and in a balanced way between different sectors of the economy. If non-agricultural sector is made to bear the developmental burden of agriculture as well, both the sectors would suffer. Rural unemployment and poverty would persist for a longer period under such circumstances. Unless pressures of excess population on land are removed through the development of industries and services, agriculture cannot become a source of strength of our economy. The estimates regarding the potential yield of direct agricultural taxation to the State revenues may differ, but it is likely to be a significant amount. Raj Committee estimates that if its proposal of agricultural holdings tax is accepted (and agricultural holdings tax replaces land revenue and related surcharges and cesses), the net additional revenue that may be collected from this tax would be around Rs 150 crores (subject to the condition that agricultural holdings tax is applied to all holdings with rateable value of Rs 5000 and above). One may add that with rapid increase in agricultural prices and incomes since Raj Committee report, the likely yield of AHT is far larger. This yield arising out of a tax on agricultural property and on capital gains arising out of transactions in such property (again proposed by Raj Committee) was estimated to be around Rs 100 to 150 crores. The yield of income tax by partial integration of agricultural income with non-agricultural income would be additional. Thus, once tapped, these taxes are likely to become an important and elastic source of income to the States.

Taxing agricultural inputs like fertilizers, electric pump sets etc. is not to be taken as an alternative to taxable agricultural income. These are indirect taxes which go to form a part of the cost of production of agricultural commodities and stand on a different footing. A farmer can avoid them by not using these inputs. This is a kind of production tax which a factory owner pays for inputs he uses, or a sales tax which a consumer pays when he buys certain items. Taxing agricultural incomes and wealth is parallel to taxing non-agricultural incomes and wealth, and should be treated on par with each other.

A rational structure of agricultural taxation including a tax on agricultural income is also needed to check evasion of tax on non-agricultural income. Assessees having both non-agricultural and agricultural incomes find a ready escape route by describing a part of their own non-agricultural income as agricultural one. Agricultural farms, vineyards, and orchards, etc. are acquired so that the assessees inflate their incomes from them in order to reduce their tax liability on income which is actually non-agicultural in origin. In the view of Wanchoo Committee[6] agricultural income should be subjected to a uniform tax which should be more or less on par with tax on non-agricultural income so that the tax assessees do not have an incentive to ascribe their income from one source to the other. Agricultural income tax, however, is a State subject. A complete integration of agricultural and non-agricultural income for levying income tax would require an amendment of the Constitution. Wanchoo Committee suggests[7] that for this purpose either Entry 82 of the Union List and Entry 46 of the State List should be amended suitably, or the States may authorize the Union Government, under Article 252, to impose income tax on agricultural incomes as well. Still another alternative would be to amend Article 269 by including taxes on agricultural income in the list of taxes levied and collected by the Union, but assigned entirely to the States. It is, however, maintained that the States are opposed to a constitutional amendment. In this connection, Raj Committee was of the opinion that a complete integration of agricultural and non-agricultural incomes would not ensure a check against tax evasion. Since agricultural incomes are difficult to determine, the assessees would now find that they can 'reduce' their non-agricultural income by showing inflated losses on agricultural side. It was necessary, therefore that 'losses' from agriculture be set only against future gains from agriculture. In case of complete integration of incomes this kind of demarcation will not be possible. An alternative, therefore, was to partially integrate the agricultural income with non-agricultural one so as to enhance the tax liability of the assessee on non-agricultural incomes only. This recommendation of the Raj Committee was incorporated in the Finance Bill of 1973.

It may be mentioned that the problems of taxing agricultural incomes were noted by Wanchoo Committee also. The Committee noted that 'levies pertaining to agricultural income or holdings have

[6]Direct Taxes Enquiry Committee, *Final Report*, 1971, pp. 40-42.

[7]Ministry of Finance, Government of India, Direct Taxes Enquiry Committee, *Final Report*, December 1971, para 2.130.

baffling variations from State to State and there is no uniformity regarding the tax base or the rate structure.... There is also a great inequity between the incidence of tax on agricultural income and that on non-agricultural one."[8] The Committee recommends that "uniform and progressive taxation of agricultural income is urgently necessary for the purpose of ensuring that agricultural income ceases to offer any scope for tax evasion, and also on grounds of equity and distributive justice."[9] The Committee rebuts the argument that a tax on agriculture income will act as a disincentive to increase output. It is pointed out that less than one-fifth of the agricultural holdings in India cover more than 61% of the cultivated area in the country. There is a large scale concentration of agricultural incomes in a few hands, and therefore with a reasonable exemption limit, there is no fear of imposing any hardship on those sections which cannot bear that burden. The Committee also took note of the fact that there would be difficulties regarding maintenance of accounts in this sector. But it pointed out that the problem will be sufficiently mitigated by exempting the lower incomes and the remaining incomes can be assessed on the basis of local information regarding crops and prices. The latter clue was picked up by the Raj Committee and developed into a more scientific and objective scheme of agricultural holdings tax.

A New System of Agricultural Taxation

The complex and unwieldy variety of agricultural taxation has been noted earlier. It follows that there is an urgent need to remould the whole agricultural tax structure along rational lines and infuse uniformity and buoyancy into the system. The Raj Committee which submitted its report in October 1972 noted that a rational system of direct taxation of agriculture should satisfy certain criteria. The tax system should be progressive in nature and should not cause an unduly heavy burden on the farmer. At the same time, the treatment of farm incomes should be on par with non-agricultural incomes for the purposes of assessing tax liability. The new tax system should remove the lack of uniformity in agricultural tax incidence in different parts of the country as also between different areas in the same State. To this end, therefore, it should be based upon agricultural productivity and prices and should be able to reflect changes in both. The system should also conform to the principle of progressiveness. The Committee noted that agri-

[8] *Ibid.*, para 2.123.
[9] *Ibid.*, para 2.124

culture can be taxed directly by integrating taxation of agricultural and non-agricultural wealth. Without any constitutional amendment, the Central Government can levy such a tax. But wealth tax cannot be considered a principal instrument of resource mobilisation from the agricultural sector. If in order to bring in enough of returns from this tax, the exemption limit is lowered sufficiently, a host of practical problems will be encountered. There will be problems of identifying potential assessees and the valuation of taxable assets. Due to the fact that Indian farmers are to a large extent illiterate and do not keep accounts, this will give rise to harassment by the officials and probably a diversion of wealth from investment in agriculture to investment in gold etc.

The Committee therefore searched for a tax base which involves a minimum possible discretionary discrimination on the part of the tax collecting officials. The discrimination, if any, had to be general and impersonal such as farmers growing crop A being taxed higher than farmers growing crop B etc.

Agricultural Holdings Tax

The committee came up with the concept of Agricultural Holdings Tax having the following features:

(1) In order to divide agricultural lands into homogeneous groups reflecting equal productivity (and hence equal potential income per hectare to the land owners), the whole country should be divided into a large number of districts and tracts. Such a division should be such that each district/tract is sufficiently climatically homogeneous. Within each district or tract, the output of different possible crops (or groups of crops) per hectare should be worked out on the basis of the estimates of the yield for the previous 10 years. These outputs should then be converted into money terms by using the average prices of the preceding three years. These output and value estimates, obviously, would have to be worked out each year and the standard gross yield per hectare for different crops estimated.

(2) Out of standard gross yield per hectare deduction for the cost of cultivation should be allowed according to a set pattern indicated by the Committee. Such deductions would be different for different crops and for irrigated and other lands etc.

(3) The land holdings of a family (consisting of husband, wife and minor children) should be considered for assessment. Actual crops grown (harvested) on it and the standard net values of the produce per hectare for different crops would be used to estimate the rateable value of the agricultural holdings.

(4) If in any year, the average output of a crop in a district is less than half the average output of earlier ten years, the rateable value of land under such a crop should be taken at zero.

(5) The actual tax liability of the family is determined as follows: from the rateable value of the holding, 20% (subject to a maximum of Rs 1000) would be deducted as a development allowance. If the balance is say 'y' thousand, then it should be taxed at a rate of 'y'/2%.'

The Agricultural Holdings Tax is a simple and effective concept and incorporates most of the features of a good agricultural tax. AHT is in effect a way of making crop cesses, hitherto levied in an *ad hoc* fashion for selected crops.[10] It is based upon the concept of agricultural productivity and has progressive rate schedule. Moreover, an important side-advantage of AHT (as we shall discuss below) is that it checks the tendency to split nominal ownership of land while maintaining the holding more or less intact for operational purposes. Since the tax is to be levied on operational holdings and on a family basis, the scope of illegal concealed leases is reduced. It not only checks tax evasion, but also helps the tenants in the protection of their rights. In the case of trust land, the holding should be notionally divided amongst the beneficiaries of the trust income in the same proportion in which the trust income is enjoyed by them. In case the individual benefits cannot be ascertained, the AHT of the trust should be assessed at the minimum rate of 20% of the rateable value. The Committee specifically ruled out any concession to charitable or religious trusts to plug the possible use of such devices for avoiding agricultural tax. Regarding the cooperatives the Committee maintained that an exemption in their case would bring in a host of bogus cooperatives. Such lands should be notionally divided in the agricultural holdings of the owner families. Those cooperative lands which cannot be identified with individual families should be notionally divided equally between the members of the cooperatives for the purposes of assessment of the agricultural tax. Regarding agricultural companies, other than plantations, the Committee recommended that they be assessed on the same basis as agricultural families subject to the condition that the tax liability would not be less than 20 per cent of the rateable value of their operational holdings. The plantation companies, on the other hand,

[10]K.N. Raj, "Direct Taxation of Agriculture," *Indian Economic Review*, Vol. VIII (NS), No. 1, April 1973.

should continue to be assessed by the States for agricultural income-taxation for lands actually used for plantations. The balance of the lands, however, should be assessed on the basis of the rateable value of the holdings as in the case of agricultural companies.

Integration of Agricultural Income with Non-agricultural Income for Income Taxation

We have already seen the rationale of partial integration of agricultural with non-agricultural incomes, on grounds of constitutional provisions and the need to check tax evasion. The scheme envisages that non-agricultural income of the assessee should be divided into two parts: the exemption limit of the income, and the balance. Agricultural income should be placed in between these two parts so as to push the taxable part of non-agricultural incomes up and into higher slabs. The tax liability should then be determined such that the liability for agricultural incomes is taken as zero, and that on non-agricultural income is assessed on the basis of the new slabs in which it might be placed.

One basic limitation of system of partial integration of incomes, however, must be noted. Under this scheme only non-agricultural income is taxed and only the rate at which it is taxed is raised. Any assessee who does not have a taxable income from non-agricultural sources will not be liable to pay income tax to the Government of India even if his agricultural income is quite large. This scheme, therefore, does not eliminate inequity as between different tax-payers, especially between those who are deriving their incomes from agriculture. A practical difficulty in administering this scheme, of course, is of computing the agricultural income. The Committee recommended that AHT payable by an assessee should not be allowed as a deductible expense for Computing income tax liability, since such a concession will wear the edge of progression in the scheme. The Committee also recommended that the additional income tax collected by this partial integration should go to the State where the land from which the agricultural income reported for aggregation is located. If the agricultural income is originating from more than one State, then the additional income tax should be divided between the States according to the proportion of the agricultural income originating within each State. The proposals of the Committee are subject to another limitation also. AHT is payable by the farmer but it leaves out rent income from agriculture. Furthermore, "such rental income is not covered by any other actual or proposed taxes."

AHT "allows the perpetuation of an anomaly and an element of regression in the taxation of agriculture. As proposals now stand, that is a valid criticism."[11]

[11]*Ibid.*

26 LOCAL FINANCE

In India, we have a number of local authorities like the village Panchayats, District Councils (or Boards or Zila Parishads), and Rural Boards. For the urban areas we have similarly municipal committees, notified area committees, municipal corporations, port trusts, improvement trusts and the like. The development of the local self-governments has been at a slow pace, but its presence completes the three-tier system of a governmental structure in which the country has the Central Government, the State governments and the local governments. Local self-government is considered to have many advantages and is supposed to be an integral part of an ideal governmental system. There are a number of functions which can best be performed by local authorities only. Such functions need local attention and adaptation to circumstances. They cannot be standardised on a State or national level. For example, the laying out of parks, street lights, scavenging and various other such services are best left in the hands of the local authorities. They need variations and adjustments from city to city. And within each city, variations are needed from locality to locality and street to street. The local residents can also point out their special difficulties, preferences, and the like in these matters and to give them full scope it is essential that their aspirations and needs should be given due weight. Moreover, these local self-governments lay the foundation for sensible and responsible training of the citizens in the matters of political, social and economic rights and obligations.

At the level of local self-government, a close link can be established between many governmental services and the collection of taxes etc. to finance them. It is far easier to base local taxes on a judicious admixture of the benefits-received principle, cost-of-service principle and the principle of taxable capacity. On a national or regional level relative taxable capacity is not easy to determine, but at a local level, it is much less difficult. Since these local bodies do not have standardised functions, nor do they have standardised sources of revenue, we can attempt only a general description of their functions and resources which are available to them.

Village panchayat is the primary unit of local self-government. A village panchayat is generally for one village but may cover more

than one village of smaller population. This body is usually an elected one and is therefore responsible to the local population. The main task of the village panchayat is to meet the local needs of the population. Its functions include judicial services, social and community services and economic services. In olden days, a panchayat was basically meant to act as a local court and the disputes of the community were referred to it for consideration and decisions. During the British days, these functions of the panchayat were mostly usurped by the regular courts. But now again, the village panchayats have been assigned some judicial functions. They can deal with offences which are within prescribed limits. This way they provide justice and compensation to the aggrieved parties without an expensive litigation.

In the same way, the village panchayats provide a number of social and community services. Through a general vigilance and the provision of watchmen etc. they are expected to provide some basi protection to the life and property within their jurisdiction. They perform the task of registration of births and deaths and in general are a source of all information and help. With the development of communications, the importance and effectiveness of a village panchayat in the life of a village community has increased further. Now it can go ahead with a number of programmes like adult education, education about general hygiene and health, improved methods of cultivation, preservation of food and the adoption of additional economic activities. The village community can be instructed about the national policies and the role which they can play in it. There is a general need, to help the villagers in knowing their rights and obligations in the society.

Apart from these social and community services, the village panchayats can also take up various economic services. For example, in addition to street lighting, scavenging and the like, provision for drinking water can be made. With the growing integration of the rural and urban economies, services in the field of providing fertilizersc and pesticides, harvesting, warehousing, marketing and the like are assuming an ever increasing importance. Building and maintenance of local roads, local minor irrigation projects, drainage, bunding and terracing of lands and the like come within the purview of the village panchayats. To put it briefly, village panchayats have an ever expanding field of functions before them, for which they should be properly developed and organized.

District councils do not enjoy an enviable position. It is a little difficult to define their area of functions. They are wedged in between

the State governments and the village panchayats. As a result there is a tendency for their functions to be usurped at both the ends. In general, however, the district councils are concerned with those functions which are not of fully local nature but which do not cover the whole State either.

Coming to the urban local bodies, we have the municipal committees for the towns and smaller cities and municipal corporations for the bigger cities. These bodies are elected ones. The municipal corporations have wider functions and powers than the municipal committees and quite often, the State or the Central Government concerned appoints an administrative officer as incharge of the executive wing of the corporation. The State (or the Central) Government also provides a number of experts to a municipal corporation so as to enable it to perform its functions more efficiently. The municipal corporations have generally more functions to perform than the municipal committees. They would, for example, undertake education upto the middle level, sanitation, water supply, street lighting, scavenging, local roads, drainage and the like. Quite often, they are also entrusted with local transport, medical services including dispensaries and hospitals and the like. Other local bodies like the port trusts, improvement trusts etc. are specialized local bodies with specially demarcated functions. Their sources of finance are more or less determined by the statutes bringing them into force. Notified area committees are meant for those municipal areas from which sufficient income is not expected on account of the predominance of government property etc., but for which local services are needed anyway. We can think of cantonments in this connection. These committees usually consist of nominated persons and subsist primarily on grants from the State or Central Government.

Thus in our country, we have three patterns of local government: (*a*) the panchayat raj pattern, (*b*) the municipal pattern, and (*c*) special bodies like port trusts etc. Panchayat raj pattern covers the rural population and moves from the village to the district level. Municipal bodies cover the urban population in the form of municipalities, municipal corporations, notified area committees and cantonment boards. All local bodies of the patterns (*a*) and (*b*) are created under the State Municipal Laws, except the cantonment boards which owe their origin to a Central Act called the Cantonment Act, 1924. In any case these local bodies, whether elected or nominated, are creatures of higher authorities and derive their powers and duties from specific legislative pieces. As a result, these different types of local bodies are not similar to each other and one notices variations even

in one type of these bodies not only from State to State but also within the same State.

It should be noted that the responsibilities of the local bodies have been growing with the passage of time and currently they are being entrusted with more and more of developmental activities, especially for the purposes of rural economic development.

Increasing functions imply increasing need for resources. But unfortunately local bodies have the chronic problem of inadequate resources. This is in the very nature of things. The services to be provided by the local bodies are quite wide and essential to the life and health of the community. But their powers to raise revenues are limited. To a large extent the State Governments have retained the taxation powers mentioned in the Constitution while in all fairness, some of the smaller heads should have been reserved for the local authorities. And with the development of the economy and the increasing awareness on the part of the public the responsibilities of the local authorities are mounting up while their revenue resources are not increasing as rapidly. Quite a few of the new services can be provided only at huge initial capital cost which these bodies cannot afford on their own. The result is that just as the States are inherently dependent upon the Centre for financial aid, the local bodies are inherently dependent upon the States. Apart from the shortage of financial resources, the local bodies are often considered inefficient. Therefore, on the one hand, more tasks are coming their way and on the other, certain developmental and other activities like land development, generation and distribution of electricity etc. are being entrusted to special bodies created for the purpose. Let us, however, look at the important sources of revenue of the local bodies. Their financial resources may be divided into two categories, tax revenue and non-tax revenue. Non-tax revenue would include grants from the State Governments, earnings from public undertakings like water supply and transport, earnings from certain remunerative activities like leasing out of lands, buildings and plots, etc. It would also include fees, fines and payments for certain services.

The Scheduled Tax Rates framed under the Government of India Act, 1919 contained an exclusive list of taxes to be utilised by or for the local authorities. The Government of India Act, 1935 put every local tax into the basket of the tax resources of the Provincial Governments. The same scheme was incorporated in our Constitution also whereby the tax resources are shared between the Centre and the States and it is for the States to hand over tax resources to the local bodies out of their own List. The tax resources of the local

bodies vary from State to State and from one body to the other. There is no standardised list in this connection. And almost every tax which that local body can impose has a corresponding tax which the State Government can also impose, and the local bodies cannot protest if a State Government encroaches upon the field where the local bodies are levying taxes or which is generally expected to be their privilege. Actually, a municipal body has to have the approval of the State Government for every new tax or a revision in the rates of an old one In the nature of things, therefore, the local bodies also show a lack of responsibility and requisite effort to improve their administrative machinery. The Taxation Enquiry Commission noted this state of affairs and thought that it needed remedying by assigning a definite tax field consisting of six areas to the local bodies.

(1) The Commission maintained that the State Government should assign the proceeds of the taxes on advertisement (other than those published in the newspapers) to the local authorities. It may be noted that this tax can better be levied by the local bodies themselves and retained. This is an important source of income to big cities in which quite a large number of hoardings are put up at prominent places. The use of other publicity media like neon signs, cinema slides and the like is also there All these media of advertisements have a great importance in tourist centres and in towns and villages which are situated on traffic junctions and national highways etc. For other local bodies (specially for village panchayats) this source of income is most likely to be an ineffective source unless the State Government also imposes this tax and assigns the proceeds to them The basic reason is that in small villages the advertising activity is likely to be near extinct.

(2) The second important source recommended for the local bodies was the octroi and terminal taxes. The two taxes are not always easy to distinguish and the term octroi is often used to cover them both. Technically, an octroi is a tax on the entry of specified goods into the municipal area for consumption, sale or use in production. The good so taxed is not expected to leave the municipal area at all, or at least in its original form. A terminal tax, on the other hand, is even on those goods which may be in transit through the municipal area. Terminal tax, by definition, does not admit of any remission or refund. But in the case of octroi, remission, rebate or refund may be permitted. If it is so, then we find that the system of octroi may be subject to an abuse. The trading community, through false vouchers etc. may be claiming a refund on octroi when in reality it is

not due. Similarly, if too strict a scrutiny is imposed upon refund of octroi, a lot of hardship may occur for the trading community. The Punjab Government has adopted a system of non-refundable octroi by exempting the goods not meant for consumption or sale within the municipal area.

We should also note that while octroi is limited only to goods, terminal tax can be levied on passengers also. Quite a few municipalities in the hill areas, pilgrimage centres and other tourist centres levy such a terminal tax to add to their own income and to be able to provide the tourists the necessary facilities. On balance, leaving the terminal tax on passengers out of consideration, a terminal tax on goods is not preferred to that of an octroi. Though a terminal tax becomes a source of revenue to the municipal authorities, it is not justified on moral grounds to tax the goods in transit. It may be noted that even though the Taxation Enquiry Commission considered octroi duties as unsatisfactory, still they did not recommend its abolition. Instead they suggested a number of steps to improve this system. They suggested that octroi duties should be levied on specific and not *ad valorem* basis. *Ad valorem* duties cause a lot of delay, inconvenience and are more open to abuse. There should be a model schedule for all the municipal bodies according to which the octroi duties should be levied. The schedule should be such as to save small traders and others unnecessary botheration. The actual administration of octroi should not be left in the hands of subordinate staff. But we may note that to have high officials for administering these duties is feasible only in the case of big cities where revenue from octroi duties would justify the employment of highly paid officials for this purpose. The Commission also felt that the State Governments should abolish or reduce the octroi duties on food items. This will not only save smaller traders from an unnecessary inconvenience, but will also be useful for the general public. This step would of course reduce the revenue from octroi duties but it can be made up through other means such as grants. A further comment on octroi would be added later in this chapter.

(3) The Taxation Enquiry Commission also wanted that the taxes on lands and buildings should be left for the municipal bodies. We note that some States have imposed taxes on urban immovable property to which the States are entitled constitutionally. But local bodies also impose these taxes and they are generally the largest source of revenue to them. These taxes are both in the nature of general tax and service charges. For example, some municipal bodies charge for street lighting, scavenging, water supply, etc. on the basis

of houses and other property situated in the locality and the valuation thereof. In other cases, a straight tax is imposed; or in some cases, for administrative convenience, a family tax is imposed. Generally, such a tax on house properties etc. is determined on the basis of the annual rental value of the property on the assumption that it is a good indication of the relative paying capacity of the tax-payers. The rates of taxation are usually progressive. They are either related to the annual rent which the tenants might be paying in the case of rented houses, or on an estimated rent if the house is occupied by the owner himself. But in both cases, the municipal authorities tend to underestimate the rental value. Moreover, it is a general practice to assess the self-occupied houses at a concessional rate as a matter of policy.

In some cases, where the municipal services enhance the value of the taxed properties, the authorities might decide to impose a betterment levy. This would be in addition to the enhancement of the annual tax flowing from the increased value base of the taxed property. A betterment levy is generally repeated often. It is often levied to meet the cost of the project/projects which caused this unearned increment. Another form of taxes on lands and buildings is that on the transfer of ownership. In addition to these taxes, the district boards might levy a cess on lands. And as noted above, taxes on buildings need not be purely on a rateable value basis only. The municipal authorities provide various services like street lights, scavenging, drainage, etc. A charge for such services could be levied on the basis of lands and buildings either on a flat rate or with some reference to their rateable value. Of course, once the tax liability is determined on an annual value basis, a number of problems crop up. The value of a property has to be ascertained and has to be revised periodically. The local bodies usually do not have trained staff for this purpose. Furthermore, it is generally thought fit to impose such a tax on progressive basis, and this causes further difficulties. It may also be noted that government property is exempted from municipal taxation.

(4) The Commission also recommended that taxes on vehicles other than those on motor vehicles should be reserved for the local bodies. Such taxes, therefore, would include taxes on hand-carts, animal-driven carts and other vehicles. Most local bodies are in fact imposing these taxes and in some cases they are being assigned a share of the Motor Vehicles Tax.

(5) Taxes on animals and boats was another category which the Taxation Enquiry Commission wanted to be reserved for the local

bodies. We find, however, that village panchayats usually find it difficult to levy a tax on animals because it is an unpopular tax. In urban municipal areas, of course, this tax brings a good amount of income.

(6) The Commission also recommended that taxes on professions, trades, callings and employments should be reserved for the local bodies. These taxes are basically for the State Governments and it is for them to leave these for the local authorities. Profession tax is an old item and was not subject to any monetary limit till the Government of India Act, 1935 provided that no new levy was to exceed Rs 50 and that the existing levies should also be subject to the maximum limits, if any, provided by the Central Assembly. In our Constitution, the maximum limit of profession tax has been raised to Rs 250. Moreover, no one can be asked to pay this tax unless he is an income tax payer. On the whole, however, the total tax collections from this source are limited. In general this tax, if imposed, should not be on a uniform basis since that would make it regressive. Instead that tax liability should be related to the income of the assessee subject to limit laid down in the Constitution.

There are other sources of tax revenue also for the local bodies. They include theatre tax which might be levied on places of entertainment on the basis of a show. Different theatres could be subjected to a differential rate depending upon their earning potential. Such a tax, generally, is at low rate and can be easily borne by the theatre owners. Some municipalities levy a teh-bazari on local sellers who do not have regular shops, or on those who come to weekly 'bazaars' as sellers. Teh-bazari rates are sufficiently low for those who use pavements to sell their wares, but they are slightly higher and are charged on monthly or annual basis from those who have push carts.

The non-tax revenues of local bodies differ from one to the other as much as does the tax revenue. Some common sources of non-tax revenue are fees and fines, and charges for certain services like water supply. There are, however, some important sources of non-tax revenue which are available only to bigger municipalities or corporations. Mention may be made of the electricity generation and distribution, and transportation. But it is found that some undertakings which can be an important source of non-tax revenue, are mostly run inefficiently and become a liability. As a result, their adoption by more municipalities is not encouraged. Some municipal authorities, in their search for new sources of revenue, have set up remunerative projects cells. They are undertakingv arious commercial ventures

like building markets, flats and developing land plots and leasing them out. In towns and cities this can be a very good source of revenue, but it is still not quite popular.

States give grants (both general and specific purpose) to local bodies to meet their revenue gaps, but these grants are generally on an *ad hoc* (though annual) basis with all their attendant defects. The result is that the local bodies just cannot plan an efficient utilisation of their resources on a long-term basis and adoption of certain schemes is not found feasible. The grants are apt to be utilised in a wasteful manner and the local bodies develop a general tendency to be lethargic in raising their own resources or spending them economically. The situation is highly anomalous when we note that on the one hand the "State Governments are not in a position to force the local bodies to step up the revenues by raising the rates and effecting adequate collection" (Zakaria Committee) and on the other, local bodies require the approval of the State Governments for every new tax or revision in the rates of an old one.

The Taxation Enquiry Commission, therefore, recommended that the basic grants should be decided on objective principles involving the population, area, budgetary resources and requirements of the local bodies under consideration. They should be guaranteed on a long-term basis to enable the local bodies plan their affairs systematically. In the absence of an assured grant, the local authorities will be suffering under uncertainty which is against the basic requirements of efficient governmental service. The Taxation Enquiry Commission also maintained that these basic grants should be adequate for the normal requirements of the local bodies. Moreover, specific grants should be given in addition to the general purpose ones, on the merit of each proposal.

Another non-tax income of the local bodies consists of loans and advances. A local body may borrow from the State Government or if it is situated in a Union Territory, from the Central Government. Such loans are taken when, in the normal course, grants are inadequate to meet the expenditure requirements of a local body. These loans are of two types.

Firstly, they may be in the form of ways and means advances. The local authority, like any other institution, is likely to find that at times, the inflow of revenue receipts does not match the outflow of payments and there are temporary deficits. Ways and means advances are expected to help the local body meet this temporary gap and are obviously expected to be repaid within a short period.

Secondly, the local body might be interested in taking up a project

with a huge capital cost. Such a project may be of a type which would generate an income for the local body. Depending upon the amount of the revenue which this project is expected to generate, the State (or the Central) Government may advance a loan to meet full cost of the project; or a part of the cost may be advanced as a grant and a part as a loan. The rate of interest and other terms and conditions of repayment of the loan would be generally determined by the financial and technical aspects of the project as such.

But it should be remembered that some local authorities like port trusts and improvement trusts are, in the very nature of their existence, in greater need of loan funds. A number of their activities are likely to create self-paying assets, for which therefore it is not thought desirable to levy local taxes. Instead it is thought better to finance them through borrowings which again may come from the State (or Central) Government or the local authority may float the required loans in the market. Such loans may even be obtained from specialized financial institutions. Generally, recourse to market or the financial institutions for financing of projects entails heavier interest cost.

Now a word about octroi. The Indirect Taxation Enquiry Committee, 1977 (Jha Committee) lists a number of defects of octroi. "Octroi has been found harmful and undesirable by every Committee that examined its working in the past, whether set up by the State Government or by the Centre" (Para 9.1). Mention may be made of the Masani Committee, the Keskar Committee, the Transport Development Council, Committee on Transport Policy and Coordination and the Rural Urban Relationship Committee. Octroi is regressive in its incidence, being generally specific in nature. It is also administratively cumbersome and vexatious especially on account of the wide discretionary powers enjoyed by the municipal tax officials. This breeds corruption and tax evasion of high order. The cost of collection of octroi is also very high. The Jha Committee found that octroi had the same type of cost cascading effect as the sales tax and this encouraged the concentration of industries in urban areas to escape this taxation. Moreover, this levy imposes a heavy economic cost on the society by obstructing quick transportation of goods. For example, the Keskar Committee found that on the Mangalore-Bangalore route of 400 km a motor vehicle had to spend 45 hours 10 minutes out of which 36 hours were on account of detentions. Removal of octroi would have the effect of reducing freight cost. Jha Committee, therefore, strongly recommended the abolition of octroi and suggested various possible substitutes; but at the same time it

insisted that its main emphasis was on getting octroi abolished rather than on any particular alternative to replace it. If need be, the levy could be abolished in stages, starting from big places like Bombay and Calcutta which are largely terminal points.

State Governments, with their meagre resources, are not keen to abolish octroi which, according to Finance Minister's budget speech (1978-79), brings about Rs 250 crores to the local bodies in our country. Rather in a number of cases octroi duties have been enhanced or even imposed on hitherto exempted items. However the Government of Madhya Pradesh abolished octroi on 30 April 1977 through an ordinance. This resulted in a loss of Rs 18 crores to the local bodies for which they were provided with alternative sources of revenue. Property tax was handed over to these bodies. The turnover tax was enhanced from 0.4% to 1.25% and a new levy called *entry tax* was introduced at the rate of 1.25% of the value of goods entering a municipal area. The entry tax is being collected by the sales tax department and made over to the local bodies. The Finance Minister has promised to consider the case for compensation to the State Governments if they accept the abolition of octroi.

It has been strongly suggested by many that the chronic problem of local finance can be solved only through having an institution of municipal finance commission like the Finance Commission provided for the States. These municipal finance commissions should make recommendations so as to ensure a steady and adequate flow of resources to the local bodies through grants and loans (in addition to the assigned heads of revenues and shared taxes). These finance commissions should be appointed in each State well before the appointment of the Finance Commission by the Centre and their recommendations should be made a part of the State proposals. This would impart a stability to the financial resources of these local bodies and they would also try to be more responsive to the questions of economy and administrative efficiency. In December 1977 the Government of India appointed a committee under the chairmanship of Mr Asoka Mehta to study the working of Panchayat Raj including the question of resource mobilisation and planning and implementation of schemes for rural development and to make the necessary recommendations on financial matters to ensure adequate availability of funds.

27 CENTRAL GOVERNMENT BUDGETS FOR 1977-78 TO 1980-81*

Table 27.1 shows the broad components of the Government of India Budget for the years 1977-78, 1978-79, 1979-80, and the Interim Budget for 1980-81. It may be pointed out at the outset that as in the previous years, there has been a tendency to underestimate the revenue receipts. This is partly explained by the fact of rising prices over all these years. The Central budget relies to a great extent on indirect taxes and with rising prices there is an automatic increase in tax yield over and above the normal growth arising out of increased production. In the case of direct taxes also, as money incomes increase, the tax-payers move from lower slabs into higher ones and thus the tax liability increases faster than the growth in national income. We need not discuss the details of the receipts and disbursements as such. They are obvious from the figures in the table. Instead, we would concentrate on salient features of each of the budgets being covered here.

BUDGET, 1977-78

The annual budget of the Government of India for the year 1977-78 was laid before Parliament on 17 June 1977, while a vote on account had been secured earlier in March 1977. We shall begin with a brief description of the circumstances and objectives of the budget for 1977-78.

Circumstances and Objectives

With a change in the Government at the Centre there was a shift in the declared economic policy of the authorities. It would, therefore, be better to say a word about the reappraisal of the problems faced by our country for overhauling the role of the budgets for 1977-78 and after. An important source of all our difficulties is an inadequate rate of economic growth, in spite of a sizeable infrastructure of modern industry in the economy. Moreover, this low rate of growth has been uneven as between regions also.

*This Chapter is based upon Interim Budget for 1980-81.

Combined with slow rate of economic growth is the fact of increasing inequalities in the country. This has led to an increase in the number of people living below the poverty line as compared with 1960-61. An indication of this poverty and destitution is the fact that we are not able to purchase and consume an output of 120m tonnes of foodgrains. For comparison we may note that in the USSR a much smaller population consumes around 210m tonnes of foodgrains.

In addition to the chronic problems of growth and poverty, there is also the recurring problem of growth of rising prices. Sometimes it is claimed that our price difficulties are the result of a world-wide phenomenon, but this is not exactly the case. Our foreign trade sector is a very small portion of our national income generation and its ill-effects (as far as price situation is concerned) can always be contained through appropriate policy measures. Our problem is basically domestic in nature and emanates from rising money supply, rising unemployment and a weak public distribution system in the face of inadequate supplies. Fortunately since September 1974, there was a check on inflationary rise in prices for a period, but prices started rising again. At the time of presenting the budget, it was noted that money supply had risen by 17% in 1976-77, and there were substantial accumulated balances of the impounded wages and allowances with the authorities. A release of these funds through repayment was obviously pro-inflationary. Further, the circumstances were such that it was quite difficult to bring a reduction in money supply without sacrificing some of the avowed objectives of the budgetary policy.

We have also the chronic problem of unemployment. This unemployment manifests itself in various forms. And though precise estimates are not available, still it goes without saying that all kinds of unemployment have been on the increase.

Strategy

This leads us to the strategy which the fiscal policy could adopt in the task of solving these problems. In this connection we may note the fact that agriculture still plays a predominant role in our economy and without its proper development, we cannot hope to achieve a stage of self-sustained growth; nor can we hope to remove poverty and unemployment. The key to our rapid and healthy economic growth lies in our adoption of policies which could accelerate the growth in agriculture along modern intensive cultivation methods, but methods which would also be labour-intensive. Along with agriculture

the whole rural economy has to be geared to make a bold march forward. There has to be an integrated rural development programme in which dairy-farming, bee-keeping, and other agro-based and allied occupations have a central place. This would ensure that the employment potential of our economy is tapped fully.

In this task of integrated rural development, adequate infrastructure has to be set up. Attention has to be paid to the building of roads, houses, gobar gas plants, irrigation projects, provision of drinking water, manure, water management, education about crop management, marketing facilities, cottage and household industries etc.

Till now our development efforts, it is claimed, have been lopsided. We have emphasized the setting up of large-scale industries with modern capital-intensive technology. This has led to our increasing dependence upon essential imports of raw materials and other inputs. At the same time, scarce capital has been used in these industries without leading to a corresponding increase in employment. These industries being capital-intensive, have starved the rural side of necessary capital input and as a result, there has been not only increasing unemployment, but also large-scale migration to the urban areas with all the concomitant problems of slums and so on. Furthermore, this has kept us vulnerable to the natural elements of floods, droughts, and other problems and our agriculture (the mainstay of our economy) has not been able to provide enough of food and raw materials.

In view of the above facts, the new strategy for economic development becomes obvious. The new strategy does not ignore the role of industries which are so essential for the health of the economy from many points of view. But it does try to restore the imbalance caused between different sectors of the economy. Therefore, an important plank of the new strategy is to bring about an integrated rural development with agriculture as its central piece. In this rural development provision of roads, markets, supply of pure drinking water, increasing irrigation facilities etc. are included. There is also a provision for the development of ancillary activities like poultry-farming, fisheries, forestry etc. It is expected that an adequate resource investment along these lines has a large employment potential. Moreover, this employment potential can be tapped with relatively less of capital, without any significant migration of the population to urban areas and so on. The villages would tend to be self-sufficient in many respects. They would learn to have scientific storage, crop rotation, and the like. But all this necessitates that the use of capital resources

should be along those techniques which are labour-intensive in nature.

Along with the above, there is a need to have small scale and cottage industries. Here also, to the extent possible, the techniques of production should be labour-intensive, using the indigenous raw materials and so on. Though it is not necessary to use power in many cases, still the need for electric power cannot be over-estimated. Along with irrigation, power is needed to energize electric water pumps, run many small industries and to help the cottage industries.

Our industries are notoriously inefficient. Since they have been facing a seller's market, they have not learnt the need for curtailing costs. There is therefore an imperative need to create this urge in the industries to become efficient and reduce cost of production wherever possible. The budget, it may be pointed out, can play a limited role in this field. The budget for 1977-78 took certain steps in this direction.

TABLE 27.1

GOVERNMENT OF INDIA BUDGET 1977-78, 1978-1979 (RE) 1979-80 (BF) AND 1980-81

Rs. in crores

	1977-78 A/cs	*1978-79 A/cs*	*1979-80 RE*	*1980-81*
1	*2*	*3*	*4*	*5*
	REVENUE BUDGET RECEIPTS			
Total Revenue (A+B)	11590.19	13196.75	14582.85	15703.91
Less States' share	1798.10	1956.82	3406 02	3576.60
Centre's share (net)	9792.09	11239 93	11176.83	12127.31
A. Gross Tax Revenue	8858.38	10525.10	11624.73	12301.61
Less States' share	1798.10	1956.82	3406.02	3576.60
Centre's share (net)	7060.28	8568.28	8218.71	8725.41
(a) Taxes on Income and Expenditure	2338.63	2453.39	2701 00	2930.30
Less States' share	675.44	706 62	864.88	932.20
Centre's share (net)	1663.19	1746.77	1836.12	1998.30
(i) Corporation Tax	1220.77	1251.47	1380.00	1504.00
(ii) Taxes on Income	1002.02	1177.39	1320.00	1426.00
Less States' share	675.44	706.62	864 88	932.20
Centre's share (net)	326.58	470.77	455.12	493.80
(iii) Others	115.84	24.53	1.00	0.50

1	*2*	*3*	*4*	*5*
b) Taxes on Property and Capital Transactions	88.35	105.84	88.94	90.98
Less States' share	9.85	10.70	10.94	10.90
Centre's share (net)	78.50	95.14	78.00	80.08
(*i*) Estate Duty	12.77	13.07	13.00	13.00
Less States' share	9.85	10.70	10.94	10.90
Centre's share (net)	2.92	2.37	2.06	2.10
(*ii*) Wealth Tax	48.47	55.41	63.00	65.00
(*iii*) Gift Tax	5.56	5.85	6.25	6.25
(*iv*) Others	21.55	31.51	6.69	6.73
(c) Taxes on Commodities and Services	8858.38	10525.10	11624.73	12301.61
Less States' share	1112.81	1239.50	2530.20	2633.50
Centre's share (net)	7745.57	9285.60	9094.53	9668.11
(*i*) Customs	1824.10	2423.51	2814.00	3004.00
(*ii*) Union Excise Duties	4447.51	5367.17	5825.00	6067.90
Less States' share	1112.81	1239.50	2530.20	2633.50
Centre's share (net)	3334.70	4127.67	3294.80	3434.40
B. Total Non-Tax Revenue	2731.81	2671.65	2958.12	3402.30
(*i*) Fiscal Services	65.91	95.24	121.49	133.18
(*ii*) Interest Receipts	1440.47	1426.85	1484.67	1812.87
(*iii*) Dividends and Profits	278.92	263.59	296.60	289.20
(*iv*) Others	946.51	885.97	1055.36	1167.05

DISBURSEMENTS

Total Disbursements	9362.29	10947.62	12047.53	13568.57
Developmental Expenditure of which	3646.04	4512.24	5224.63	5162.29
1. Social and Community Services	656.05	725.35	791.89	870.82
2. Economic Services	1783.27	2034.03	2448.43	2515.52
(*i*) Agriculture and Allied Services	774.04	908.22	871.07	896.15
(*ii*) Industry and Minerals	370.93	359.11	746.78	752.95
(*iii*) Foreign Trade and Export Promotion	346.87	419.80	382.49	368.06
(*iv*) Water and Power Development	95.27	104.10	126.67	147.43
(*v*) Transport and Communications	115.34	149.89	215.21	235.44
(*vi*) Others	80.78	92.11	106.21	115.49
3. Grants-in-aid to States and Union Territories	1204.77	1751.53	1980.47	1769.23
4. General Services	1.99	1.34	3.84	6.72
Non-Developmental Expenditure of which	3330.31	3821.48	3812.46	5369.44

1	2	3	4	5
1. Audit	49.35	53.44	61.72	63.60
2. Collection of Taxes and Duties	99.65	110.57	122.05	143.29
3. Currency Coinage and Mint	66.49	44.31	39.89	44.23
4. Interest Payments	1521.34	1828.97	2206.23	2597.64
5. Administrative Services	407.33	442.78	463.93	637.70
6. Pensions and Miscellaneous	35.65	46.32	51.67	55.50
7. Grants to States and Union Territories	755.93	882.98	461.79	482.86
8. Compensation and Assignments to Local Bodies	18.82	20.15	28.75	26.51
9. Help to Other Countries	48.42	60.91	65.54	73.00
10. Other General Services	327.33	331.05	310.89	1245.12
Defence (net)	2385.94	2613.90	3010.44	3036.84

CAPITAL BUDGET
RECEIPTS

1. Market Loans				
Gross Borrowings	1309.99	1836.78	2258.80	2765.00
Repayments	124.55	183.31	297.51	265.34
Net	1183.44	1653.47	1961.29	2499.66
2. External Loans				
Gross Borrowings	803.32	853.76	939.38	1119.11
Repayments	429.19	469.90	408.78	410.40
Net	374.13	383.86	530.60	708.71
3. Recoveries of Loans and Advances	2288.27	2081.87	1584.00	2733.00
4. Small Savings (net)	544.65	847.21	925.00	1000.00
Provident Funds (net)	192.85	286.49	299.99	300.02
Special Deposits of Non-Government P.F.	308.65	401.79	399.86	449.86
Others (net)	140.75	630.36	— 253.69	738.87
Total Capital Receipts	5034.74	6285.05	5447.05	8430.12

DISBURSEMENTS

Total Disbursements	6397.56	8083.09	7279.62	8224.28
1. Defence Expenditure	247.70	253.73	262.56	263.16
2. Loans and Advances	4155.01	5565.47	4767.61	4856.18
of which				
To States and Union Territories	1956.23	3324.40	2798.52	2796.09
To others	2198.78	2341.07	1969.09	2060.09
3. Other Expenditures	25.76	276.05	4.99	635.18

1	*2*	*3*	*4*	*5*
4. Developmental Expenditure of which	1969.09	1887.84	2241.46	2469.76
(*i*) Social and Community Services	103.86	104.60	108.06	157.29
(*ii*) Economic Services	1865.23	1783.24	2133.40	2312.47
General Economic Services	40.98	85.17	52.73	48.12
Agriculture and Allied Services	— 12.55	147.40	350.76	344.68
Industry and Minerals	1298.92	827.88	781.05	861.43
Water and Power Development	121.57	192.29	312.84	371.46
Transport and Communications	121.13	143.05	178.35	214.06
Railways	274.20	361.41	397.40	374.00
Posts and Telegraphs	20.98	26.04	17.60	63.30
Others	...	...	...	...
5. General Services	...	...	42.67	45.42
AGGREGATE RECEIPTS	14826.83	17524.98	16623.88	20557.43
AGGREGATE DISBURSE-MENTS	15759.85	19030.71	19324.15	21792.85
BALANCE	— 933.02	— 1505.73	— 2700.27	— 1235.42

Source : *Explanatory Memorandum on the Budget of the Central Government and Budget at a Glance, 1978-79, 1979-80 and 1980-81.*

Tax Proposals

It might be appropriate to preface the tax proposals with the remarks made by the Finance Minister while presenting the budget before Parliament. The Finance Minister claimed that the proposals covering direct taxes "are designed to increase corporate savings, channel funds into productive investment, accelerate the pace of industrial growth and, at the same time, strengthen the redistributive role that direct taxes must be made to play."[1] The proposals concerning indirect taxes tried to ensure that they did not impinge upon the necessities of life. Effort was made to raise the resources, from "less essential or luxury items, while giving relief to some deserving sectors and simplifying and rationalising the central excise tariff structure generally."[2]

Direct Taxes

The income tax exemption limit was raised to Rs 10,000. This

[1] *Ibid.*, Part B, Para 63.
[2] *Ibid.*. Part B, Para 64.

relieved the official tax machinery and waived the tax liability for about 8.5 lakh income tax payers. However, the nil-tax slab for those who are liable to pay income tax was retained at Rs 8,000 subject to the provision that the tax liability would not exceed 70% of the income exceeding Rs 10,000. At the same time, the rate of surcharge for the purposes of the Union was raised from 10% of the income tax to 15%. It not only raised the income tax liability of the tax payers (who were still left after the raising of the exemption limit) but raised the tax liability to 80.5% on incomes immediately exceeding Rs 10,000.

Further, the existing position was that 50% of the remuneration received by Indian technicians from a foreign government or an enterprise for services rendered outside India were exempt from income tax. In the budget for 1977-78 this concession was extended to cover Indian technicians employed by Indian concerns in any branch or office outside India.

As regards wealth tax, the last budget had reduced the tax rates. The budget for 1977-78 retained the existing ½% rate for the first Rs 2.5 lakh, but for the higher slabs, the rate was uniformly increased by ½% while in the highest slab of Rs 15 lakhs and above, the rate was raised from 2½% 3½%. These charges came into effect from 1 April 1977.

While the impounding of half of the additional dearness allowance came to an end with effect from May 1977, the Compulsory Deposit Scheme for income tax-payers was extended by another two years. The rates of compulsory deposit remained the same. This provision was intended to be anti-inflationary especially in view of the fact that there were now bigger home-carry pay packets (after scraping of the scheme for dearness allowance) and greater money supply.

In the field of corporate taxation, a significant step was taken in the 1976-77 budget in the form of investment allowance. The scheme, however, had not laid down any clear cut and well defined criteria for selecting the industries which were entitled to this allowance. In the budget for 1977-78, this was sought to be remedied. At the same time, the concession of investment allowance was extended to all industries except those which are engaged in the manufacture of specified low priority items such as cigarettes, cosmetics and alcoholic beverages.

The budget took an important step in encouraging indigenous technology. Investment allowance was granted at a higher rate (35%) on machinery and plant installed for the manufacture of any article made in accordance with knowhow developed in Government labora-

tories, public sector companies and universities.

These above steps were expected to be helpful in developing internal resources as well. To that extent the industries would be less dependent upon external sources of finance like the banks, government and other agencies for the purposes of expansion. It is in this connection that the existing provision under which closely-held industrial companies were compelled to distribute high percentage of their net profits as dividends, was found redundant. The budget for 1977-78 exempted such industrial companies from this requirement.

Some changes were also made in the capital gains taxation with a view to removing impediments in the way of adequate mobility of investible resources and taking them out of perpetual investment in low priority assets. The concessional tax treatment was extended to capital gain arising out of an asset held for 36 months or longer instead of 60 months or longer (as previously). Similarly, in respect of assets acquired prior to 1 January 1954, a tax-payer had the option of adopting the fair market price of the asset as on 1 January 1954 in place of the actual cost of acquisition. Now this notional date was extended to 1 January 1964. Again, while according to the existing rule, capital gain from the sale of a residential house was fully or partially exempted provided the capital gain was utilized on a new residential house, the budget for 1977-78 extended this concession to cover the reinvestment of capital gains in shares, bank deposits, units of the Unit Trust of India or other preferred assets.

The budget also took note of the fact of there being a large number of sick industrial units. Sick units cause a national wastage of resources as also unemployment. Accordingly, the budget provided a tax concession for the parent firm in the event of merger of the sick unit with a healthy one. The budget provided that where an amalgamation was accepted by the Central Government to be in public interest, the accumulated losses and unabsorbed depreciation of the amalgamating company would be allowed to be carried forward and set off in the hands of the amalgamated company.

The budget also took steps to encourage industry in its task of helping in rural development. To that end, expenditure incurred by companies on approved programmes of rural development was allowed to be deducted in computing the taxable incomes of the spending concerns. Similarly, the budget provided for a preferential treatment to those industries which are set up in the rural areas and which begin their manufacturing activity after 30 June 1977. This tax concession would be available for ten years from the date a company starts its manufacturing activity and would consist in taxing

only 80% of its taxable profits.

The budget however withdrew the option given to companies (in 1976-77) not to pay 5% surcharge on income tax and instead deposit an equivalent amount with the Industrial Development Bank of India for a period of five years. This measure was expected to yield Rs 56 crores. The ceiling on donations for charitable purposes qualifying for tax purposes was raised from Rs 2 lakhs to Rs 5 lakhs.

The net effect of all the direct tax proposals was expected to be Rs. 92 crores in the year 1977-78.

Indirect Taxes

The proposals in the field of indirect taxation may be discussed in terms of different categories. The first category of proposals related to those which were designed to raise resources. Here the budget provided for a levy of 10% excise duty on five items, namely, (*i*) hand tools and small tools not already excisable, (*ii*) weighing machines and weigh bridges, (*iii*) watches, clocks, and time-pieces, (*iv*) electric fittings and (*v*) polishes for footwear, metals, cars, etc. However, in the case of manufacturers whose production did not exceed Rs 1 lakh, the products were exempted from this duty. Acetylene gas was subjected to a duty of 12%. Another measure in the category of raising resources was in the field of 1% excise duty which had been levied on an experimental measure in 1975 on those items which were not subject to an excise duty under any specific heads. This was a step in the direction of introducing a kind of value added tax in the country. The budget for 1977-78 raised this rate of duty to 2%. The collection under this head was Rs 37 crores per annum. Another modification introduced in this duty was administrative in nature, but economic in effect. Previously an exemption from this duty was granted on the basis of number of workers. The budget for 1977-78 granted exemption on the basis of annual turnover provided it did not exceed Rs 30 lakhs. Also all non-power units were exempted from this levy. Further, while small newspapers were already exempt from this duty, the budget for 1977-78 extended this exemption to medium newspapers also, while the big newspapers continued to pay this duty. It was estimated that the additional yield from this group of measures would be Rs 30 crores.

The duty on motor cars was raised from 15 to 17½% while that on scooters, motor cycles a ' three wheelers was raised from 9% to 12½%. At the same time, however, there was some relief on account of exemption from excise duty on tyres, tubes and batteries supplied as original equipment. These changes were supposed to yield Rs 5.1

crores per annum. The basis of taxing pigments, paints, enamels and varnishes, etc. was changed from specific to *ad valorem* and the rates were so adjusted that the duty on high cost items among this category would go up by around 5%. This measure was estimated to yield Rs 4.8 crores per annum. Similarly, the budget expected to collect another Rs 4? crores per annum by raising the duty on branded *biris* and by raising the progression of excise duty on cigarettes.

The second category of tax proposals related to the cases of reduction or abolition of excise duty. The beneficiaries included both handloom and powerloom sectors. Concessions of various types were given or extended to various types of yarn. Also previously these sectors had been given an exemption from duty if bleeching, dyeing and printing were done without the aid of power. The budget for 1977-78 extended this concession to all other types of processing without the aid of power. Similarly, the powerloom industry was exempted from the compounded excise duty and thus about 80,000 powerloom licensees were freed from excise control.

The duty on power driven water pumps was reduced from 10% to 5% and the power tillers were exempted from the general excise duty. Small paper mills also got a relief of 50% to 75% of the existing leviable duty according to their installed capacity and depending upon their use of non-conventional raw materials and waste paper to the extent of at least 50%. The larger mills got a concession of $33\frac{1}{3}$% of the leviable excise duty provided they also used at least 50% of the non-conventional raw materials. It was hoped that this concession would help in preserving our timber resources. In the match industry, those units which were members of the registered cooperative societies or were certified as such by the Khadi and Village Industries Commission were given a doubling of the concession in excise duty from 55 to 110 paise per gross of match boxes. Similarly, mini steel plants were helped by exempting their raw materials in the form of identifiable types of melting scrap cleared from the main steel plants. Duty on electric insulated tapes and various confectionary items was also abolished. Various concessions were also extended to help the electronics industry especially because it offers great scope for development in the small scale sector. Previously, the duties in this sector were partly specific and partly *ad valorem*. The budget for 1977-78 introduced a uniform *ad valorem* basis for levying the excise duties here. The large manufactures were to pay from 15 to 35% *ad valorem* (depending upon the item and ex-factory price) while the small manufacturers were given a concession of 15% and subjected to a duty ranging from nil to 20% *ad valorem*. In order to encourage a down-

ward adjustment of ex-factory prices of TV sets, tape recorders and electronic calculators, 5% concessional rate of excise duty was limited to those items with somewhat lower ex-factory prices than prevailing at the time of the budget.

The third category of indirect tax proposals related to rationalisation of various duties. The budget took some important steps in this direction.

(1) It abolished the distinction between basic and auxiliary duties by merging the latter with the former. The rationale for the auxiliary duties was that they were not shared with the States. However, the Sixth Finance Commission had recommended that from 1976-77 onwards auxiliary duties of excise should also be shared with the States. The Government accepted these recommendations. Accordingly, there was no more justification for maintaining this distinction.

(2) The second important step was in the direction of extending the *ad valorem* basis of levying the excise duties. It would be noticed that in the proposals listed above, some significant steps were taken to shift the basis of excise duties from specific to *ad valorem*. Similar approach was followed in this category of proposals also. For example, in the case of cotton fabrics, in the budget for 1976-77 a system of *ad valorem* rates was introduced, but the rates were dependent on the count of the yarn used in the fabric. The budget for 1977-78 adopted the *ad valorem* system irrespective of the count of the yarn and with a high degree of progression built into it.

(3) The nomenclature and classification of textile yarns and fabrics underwent rationalisation. The new classification was based upon the fibre predominating by weight. This not only simplifies the administration side of these duties, but also enables the textile industry to use more of polyster fibre without attracting higher duty on the yarn produced. This was expected to ease the pressure on demand for cotton.

(4) Certain adjustments in duty structure were made to reduce evasion and malpractices and help in tapping employment potential and production possibilities. For example, excise duty on woollen yarn (which had to be collected from a large number of small spinners) was replaced by an import duty on raw wool, waste wool and rags. Excise duty on wool tops was also reduced from Rs 10 per kg to Rs 5 per kg. These steps were expected to reduce the cost of fabrics using indigenous wool. Similarly, the duty on bars, rods, angles, etc. was shifted to the ingot manufacturing stage. The cloth produced by power looms was made duty free. Import duty on newsprint was reduced from 5% to 2½ *ad valorem*. However, reduction of

import duty on watches from 120% to 50% *ad valorem* does not stand scrutiny on logic (because it is a non-essential item compared with certain other consumer items like edible oils which were in short supply at the time of presenting the budget) except that the Government was not able to check the smuggling of watches effectively and wanted to stop it by meeting the excess demand through importing watches through HMT. There were numerous other similar minor modifications in the Central Excise Tariff.

(5) There was also an effort to introduce an element of cost-consciousness in the domestic industry by exposing it more to competition from abroad. For this import of certain selected items of capital goods without prior scrutiny from the indigenous angle (that is without verifying whether the same could be supplied by the home producers) was permitted. It is, however, debatable whether it is desirable at this stage to expose our producers to a stiff foreign competition. On the other hand, it was claimed to have the salutary effect of reducing the cost of production of many items especially on account of a reduction in import duties on certain items, such as, copper wire and bars, cold-rolled non-grain oriented sheets, alloy steel, tool steel, special steel, high carbon steel, stainless steel plates and utensil grade stainless steel.

Comments

It may be claimed that the budget was by and large price-neutral in effect. The increase in indirect taxes (which usually are price inflationary) was confined to mostly less important items or is the result of some rationalisation or shifting from specific to *ad valorem* taxation. At the same time, there was a more liberalized import policy envisaged in the bedget. There was a reduction in certain excise duties such as on handlooms and powerloom fabrics, as also a reduction in certain important duties. The budgetary deficit, claimed to be just Rs 72 crores was somewhat illusory and is the product of the definition of the deficit. Actual deficit turned out to be Rs 950 crores. It should be noted that the budget provided for special borrowings from the Reserve Bank of India against its foreign exchange reserves equivalent to Rs 800 crores. Similarly, the budget provided for a borrowing of Rs 130 crores against the impounded Compulsory Deposit funds which could not be termed anti-inflationary by any means. However, a redeeming feature, from the point of view of controlling prices was that the budget provided for impounding of the second instalment of Compulsory Deposit funds due in July 1977 (Rs 326 crores). The net result of all the budget proposals and

allocations together with the fact that in the previous year money supply had risen by 17.1% could not be claimed exactly price-neutral or anti-inflationary in impact.

The budget encouraged investment and employment, but to limited extent only. It extended the concession of investment allowance, encouraged small scale industries and the use of indigenous technology. But it is difficult to understand why the tax concession should not be extended to the use of technology developed by a private organization in the country.

The budget for 1977-78 did not meet a number of expectations which had been raised in the minds of the public. The objectives proclaimed by the new party in power were obviously contradictory, especially in terms of containing inflation through cutting down public expenditure and encouraging investment activity in the country. According to the needs outlined and the strategy of investment and fiscal policy, power, agriculture and allied activities should have got a much larger outlay. Though in absolut terms the budget outlay in these sectors was raised, the increase was only marginal (30.4% as against 29.4% in the previous budget). At the same time we note that industry and minerals and other sectors had a correspondingly increased allocation. Officially this was explained by pointing out that the on-going projects ought to be completed and that necessitated this huge allocation. However, this argument holds only partially.

It may also be maintained that the budget did not add to the incentives for savings apart from the incentives which were already there. In view of the increased money supply, rising prices and threat of further inflation, there was a need to make a real big thrust in the direction of encouraging savings. The budget encouraged investment without taking care of the savings side.

BUDGET, 1978-79

On the eve of the budget for 1978-79, our economy presented a mixed picture of both opportunities and hindrances. On the opportunities side we had the favourable position of food stocks and prospects of a good rabi crop. Our foreign exchange reserves had been increasing at comfortable rates and we could pursue a policy of selective liberalized imports. Though prices had not been exactly stable, any sizeable inflationary rise was missing. On the other hand, the hindrances and problems had also gained in strength. For example, the very existence of large food stocks and foreign exchange reserves are inflationary in their nature because they add

to the effective money supply in the country without a corresponding addition to the supplies. The position regarding industrial relations, power supply and the like was not happy. Industrial production was lagging behind. Our plan target for 1977-78 had not been achieved (even though the increase in annual plan outlay in 1977-78 was only 27% compared with 31% increase in 1976-77). Our industries were suffering from a phase of recession in demand and there was a large scale sluggishness in industrial investment. Various measures to stimulate it during the year 1977-78 had not met with much of a success, and the Finance Minister even admitted that he was not able to pin-point precisely the causes for this sluggishness. According to one analysis, the basic reason lay in reduced plan outlay which is always a major source of demand for industries in the private sector. At the same time, uncertain power supply and other factors were coming in the way of industrial stimulation.

Another important problem which had gained in strength was that of unemployment. For this, industrial activity in the urban areas and agricultural and allied activities in the rural areas appeared to be the remedy. It implied that on the one hand, the problem of industrial recession must be solved and on the other steps must be taken to generate greater vigour in the rural economy. Amongst other things, therefore, there was need to try for increase in power generation capacity as also an addition to irrigation potential. Revival of small scale and cottage industries became a matter of both necessity and strategy for reviving the economy and removal of unemployment.

Removal of unemployment, revival of the economy and use of labour-intensive techniques are all inter-related. Their solution necessitated remedying the situation of recession. Analysis of the situation led to a general belief that quite a few steps were needed to solve the problem of recession and sluggishness in industrial investment. Firstly, pleas were being made to step up plan outlay which could provide a major source of demand to the private sector also. Secondly, there was a need to improve the whole structure of taxation.

The industrial community was pleading for various concessions in direct taxation to increase profitability of investment and stimulate industrial activity. At the same time various procedural reforms were being sought in direct taxation. The interim report of the Chokshi Commitree and the final report of the Jha Committee had provided an opportunity for the Government to initiate some steps in the direction of tax reforms. The Jha Committee had emphasized that the whole system of indirect taxation needed overhauling. Amongst other things, it had recommended that the government

should avoid taxing inputs and intermediates because it led to the cost-cascading effects. The Committee had suggested that pending the introduction of a system of value-added tax, the authorities should avoid taxing on a selective basis and instead make across the board changes in the indirect taxes.

The Government was thus facing a host of objectives and questions which needed immediate attention. Apart from a reformation of the tax system, there was a need to raise plan outlay which implied raising of larger tax resources and borrowings. The Finance Ministry was of the view that there was not much scope left for increasing direct taxes. An important sector which is still undertaxed in our economy is agriculture. Here the Government, instead of imposing adequate taxes, is actually subsidizing various inputs. (The State Governments, in their turn, are not taxing this sector adequately and are providing subsidized inputs like water etc). At the same time, it was essential that the Government should avoid resorting to heavy deficit financing in order to keep inflation in check.

We find that in number of these fields, the budget failed to provide a proper remedy Instead, some of the budget proposals worked towards worsening the situation We shall see these defects in the last portion of this section.

The Budget Proposals. The budget estimates based upon 1977-78 rates of taxation showed a gap of Rs 1396 crores in spite of the fact that the plan expenditure was raised by only 17% over the figure for the outgoing year. This gap was partly filled by various budgetary proposals.

Direct Taxes. The Government was of the view that not much scope was there to enhance direct taxation. In the previous year, surcharge on income tax had been raised from 10% to 15%. Accordingly no change in income and wealth taxes was made.

In terms of proposals which increased the revenue, we note the following:

(1) A weighted deduction was being allowed in the computation, of taxable profits with reference to expenditure incurred by Indian companies abroad and resident tax-payers on development of markets. This weighted deduction was at the rate of 150% of the actual expenditure in the case of widely held companies and 133.3% in the case of closely held companies. This weighted deduction was lowered to actual expenses. Correspondingly, a curb was imposed on the advertisement expenditure within the country by disallowing a part of such expenditure on a slab basis. These two measures were expected to net in Rs 8 crores and Rs 10 crores respectively.

(2) To ensure that winnings from horse races are brought effectively within the tax net, the deduction at source was raised to 34.5% from winnings in excess of Rs 2500. This measure was expected to net in Rs 3.5 crores in 1978-79 and Rs 4 crores in full year.

(3) Compulsory Deposit Scheme withdraws money from circulation and reduces the effective amount at the disposal of the tax-payers. But it is not a tax. Here the budget increased the rates of compulsory deposit so as to net in Rs 25 crores a year.

This brings us to the category of concessions in direct taxation.

(1) In order to encourage long-term savings through life insurance, provident funds etc., the deduction for income tax purposes at the rate of 100% for the first Rs 5000 (instead of the existing Rs 4000), 50% for the next Rs 5000 (instead of existing Rs 6000) and 40% of the rest was proposed. The monetary limit of the qualifying savings was also raised. This concession was expected to result in a revenue loss of Rs 10 crores in full year and Rs 7.5 crores in 1978-79.

(2) Tax on interest earnings of scheduled banks was abolished resulting in a revenue loss of Rs 133 crores per annum (Rs 108 crores in 1978-79). Consequently, interest rates on all bank deposits and loans were also reduced. This measure was claimed to stimulate investment.

(3) Another concession was to stimulate investment in new ventures. For this a deduction in the computation of taxable income of 50% of the amount invested in equity shares of *new industrial companies* was provided subject to a limit of Rs 10,000 p.a. The expected loss was Rs 5 crores in one year and Rs 3.5 crores in 1978-79.

(4) Similarly, to divert funds to new equity shares, the concession of capital gains was withdrawn from investment into existing companies.

(5) To encourage new buildings by the employers for their low-paid employees, the initial depreciation allowance was raised from 20% to 40%.

(6) The exemption limit for estate duty was raised from Rs 50,000 to Rs 1 lakh.

(7) The concession of capital gains was withdrawn for bank deposits.

These proposals in the field of direct taxes were expected to bring in Rs 55 crores (including Rs 25 crores by way of compulsory deposits) and Rs 50.50 crores in 1978-79. With the withdrawal of interest tax, however, the net revenue *loss* was to be 57.50 crores (Rs 82.50 crores if compulsory deposits are ignored).

Indirect Taxes. The Finance Minister concentrated mainly upon indirect taxation for raising the needed resources which meant a reliance on excise duties.

(1) A levy of two paise per kwh was levied on the electricity generated. However, electricity generated for captive consumption, electricity used in auxiliary plants in the generating stations for the generation of electricity and electricity used for agricultural purposes were exempted. The estimated yield of this levy was Rs 145 crores.

(2) Coal was subjected to an excise duty varying from Rs 5 to Rs 10 per tonne and was expected to yield Rs 58 crores.

(3) Under Item 68 of the Central Excise tariff, the rate of duty on "all articles, not elsewhere specified" had earlier been raised from 1% to 2% *ad valorem.* The budget raised this rate to 5% *ad valorem* with exemption for some sensitive categories like pesticides, weedicides, insecticides, fungicides, drugs and medicines, pharmaceuticals and drug intermediates and newspapers and periodicals. The expected yield from this levy was Rs 160 crores.

(4) All goods subject to basic duties were subjected to a 'special duty' of excise at the rate of 5% of the basic duty with an expected yield of Rs 214 crores on indigenous production and Rs 15 crores by way of increase in countervailing duties on imports.

(5) Certain other measures in the nature of rationalisation of duty rates on items like coated fabrics, cigars and cheroots, tea waste, vegetable products, and certain modifications in the customs tariff for protective purposes were expected to bring in Rs 12.4 crores p.a.

(6) Concessions to small-scale industries were sought to be rationalized and increased. Accordingly, all small-scale units manufacturing specified goods, whose clearances in the preceding year did not exceed Rs 15 lakhs were exempted from the duty payable on first clearance of Rs 5 lakhs. The exemption covered 69 items and 24,000 small-scale units. The expected revenue loss was Rs 28 crores.

(7) Power driven pumps mainly used in agriculture were exempted from excise duty leading to a loss of revenue of Rs 1.5 crores p.a.

(8) The concession available to motor vehicles being used as taxies was extended to 3-wheelers and auto-rickshaws as well. Similarly, other concessions on various items were also granted. These entailed a revenue loss of Rs 7.58 crores.

(9) Customs duties on specified items of capital equipment not produced within the country were reduced from 40% to 25% with a revenue loss Rs 9 crores. This step was in line with a recommendation made by the Jha Committee.

Inclusive of the abolition of interest tax, the total yield from the budgetary measures was Rs 441.5 crores (Rs 449 crores of indirect taxes, Rs 25 crores of compulsory deposits, and a *loss* of Rs 82.50 crores of direct taxes.) Of this amount the share of the States was Rs 95.5 crores and that of the Centre, Rs 346 crores.

The uncovered deficit after the tax proposals was put at Rs 1050 crores on top of a deficit of Rs 950 crores in 1977-78.

Plan Outlay. Total outlay provided for plan purposes in 1978-79 amounted to Rs 11649 crores as compared with Rs 9960 crores in 1977-78. Of this the Central Plan outlay was Rs 5664 crores and that of the States and Union Territories together was Rs 5785 crores. For the first time, the States and Union Territories Plans together were larger than the Central Plan. It was claimed that this fact reflected a recording of our Plan priorities in favour of agriculture, irrigation, power and rural development all of which figure prominently in States Plans and in some measure a shift towards greater decentralization in planning. Rs 10465 crores out of the aggregate of Rs 11649 crores were meant for the continuing schemes; Rs 150 crores were allocated for new power projects and Rs 1034 crores for schemes under other sectors. Out of Rs 1034 crores about 80% (Rs 828 crores) were allocated for the development of rural areas.

Comments. It would be now in order to discuss the extent to which the budget succeeded in its objectives. The Finance Minister in his Budget Speech asserted that "I have kept in view the fact that a substantial increase in investment has necessarily to be backed by increased efforts at mobilisation of savings. My proposals in the field of direct taxes are accordingly designed to promote larger savings; to curb extravagant and wasteful expenditure in business and profession; and to channelise funds for stimulating growth and production. I have also sought to provide some tax relief in selected areas with a view to encouraging large investment in desired direction." It is found that the budget did try to encourage investment by abolition of interest tax and reducing the interest rates on bank deposits and bank loans. More particularly, it tried to encourage investment in new industrial companies. But these measures were counter productive. The reduction in interest rates made marginal change in the total production cost of industries. And it was a positive disincentive for savings. Moreover, the conditions imposed for enjoying the tax and capital gains concessions for investment in the equity shares of new industrial companies were very difficult to comply with.

On the other hand, we find that the investment in existing companies and expansion thereof is equally stimulating for the economy.

But for that purpose the concession was not extended. Rather, in that sphere, curbs on advertisement and a spate of indirect taxes were the major hampering causes. Investment in unorganized sector was also being left out. All told, therefore, the budget provided only a limited inducement, if any, for business expansion.

The budget contained various measures which discourage investment. There were curbs on advertisement. Increase in plan outlay was much smaller (only 17% as compared with 27% in the preceding year). And on top of this an all round increase in excise duties was bound to bring about cost-inflation. More perturbing was the fact of levies on electricity generation and coal. All told, these levies were bound to raise the costs of both production and freight and thus contribute to what is called the cost-cascading effect. The railway budget was also bound to be upset by levies on coal and electricity.

The agricultural sector was again left out of the tax net. Instead of removing the huge subsidies on various inputs (which basically benefit rich farmers only), the budget extended certain concessions to them.

Thus, even after borrowing more than Rs 1800 crores, the budget was left with a huge deficit, mainly due to the fact that it abolished interest tax, did not tax agricultural inputs and did not reduce subsidies. With maintenance of interest tax and taxing of agriculture, the budget could avoid this huge deficit. Instead, it brought in a record amount of indirect taxes on all inputs (especially on coal and electricity). On the one hand, therefore, the budget courted inflation through deficit financing and on the other by resorting to cost-escalation steps. It may be remembered that the government itself is a major consumer of the items brought under heavier indirect taxation resulting in a vicious circle of its own. It is worth noting that the budget relied upon indirect taxation and deficit financing to such an extent that there was a *net reduction in direct tax revenue* even after allowing for compulsory deposits.

It was a correct policy in the budget to concentrate on the completion of the continuing schemes so as to reap the advantages of quicker production. But this approach left only about 10% (Rs 1034 crores) for new plan schemes, out of which Rs 828 crores were provided for rural development. Obviously this amount was insufficient to impart the necessary rural bias in our plan programmes. The resultant impetus to rural development and employment could therefore be quite marginal.

BUDGET, 1979-80

The budget for 1979-80 faced a situation of large scale unemployment in the country. The price situation was getting difficult and inflationary pressures were mounting up and threatening to disrupt the flimsy price stability. The outgoing year had ended with a large scale addition to bank credit as also to the budgetary deficit which turned out to be Rs 1590 crores as against the budgeted figure of Rs 1071 crores. This was in addition to Rs 555 crores which the States had spent by way of overdrafts from the Reserve Bank of India and which the Centre had taken over. There was a need to step up and maintain agricultural and industrial investment and output with special emphasis on small scale industries, power and irrigation, coal, cement and the like. The Finance Minister in his budget speech maintained that "if the resources needed for development are to be raised without inflation, there will have to be a greater readiness on the part of people who can bear further taxation to shoulder additional burden." He also emphasised the need for increasing savings in the ecocomv and curtailing government expenditure "particularly such subsidies as do not serve any specific social or economic purpose." He wanted "to accelerate the pace and thrust of programmes which have a material bearing on agricultural growth and promotion of employment."

The budget provided for marginal increases in various schemes directed at promotion of agriculture, village industries and the rural sector in general. The budget had also to cope with the fact that in view of the recommendations of the Seventh Finance Commission, a greater devolution of Central taxes and duties were to be made to the States. At the existing level of taxation, States' share in 1979-80 was estimated at Rs 3235 crores which was Rs 1278 crores more than the figure in 1978-79. This had the effect of reducing the Centre's net tax revenue (at the existing level of taxation) by Rs 620 crores. Total receipts of the Central Government (at the existing level of taxation) were placed at Rs 16551 crores in 1979-80, while the total expenditure was placed at Rs 18526 crores, leaving a gap of Rs 1975 crores.

The Finance Minister in his budget speech maintained that his tax proposals aimed at three objectives in addition to that of resource mobilisation. The first was to reduce income and wealth disparities. The second was to increase production and avoid waste. The third was the elimination of unemployment and underemployment by

stimulating agricultural production, by encouraging labour intensive techniques of production and by improving the competitive capacity of small scale and cottage industries in relation to large scale industry.

Direct Taxes

In the light of above comments and situation, the budget for 1979-80 made the following proposals in the field of direct taxse:

Surcharge on income tax was raised from 15 to 20% of the tax. This surcharge is not shared with the States. Similarly, surcharge on corporation tax was raised from 5 to 7½%. These two surcharges were expected to yield Rs 65 crores in 1979-80 and Rs 81 crores in full year. It may be noted that the surcharges are expected to be only for temporary exigencies, but in India they have come to stay as a permanent feature of the tax system. The increase in rate of surcharge is partly explained by enhancing of the States' share in income tax from 80 to 85% by the Seventh Finance Commission.

The rates of wealth tax were raised for higher slabs. The additional yield in 1979-80 was expected to be zero but in 1980-81 it was expected to yield Rs 6.6 crores. The budget also withdrew exemption on capital gains tax and was expected to yield Rs 14 crores in 1980-81. The concession of tax holiday which was available to all industrial undertakings going into production before 1 April 1981 was withdrawn from non-priority industries. Some concessions given on long-term savings were reduced, leading to an expected yield of Rs 7.6 crores in 1979-80 and Rs 9.6 crores in full year. The threshold for payment of advance tax by firms was lowered from Rs 30,000 to Rs 20,000 and was expected to yield Rs 12 crores in 1979-80. The budget also proposed to levy a tax on gross receipts of luxury hotels. The details were to be worked out later.

The Compulsory Deposit Scheme was extended for another two years and was expected to net in Rs 160 crores in 1979-80.

The budget also provided certain *concessions* in direct taxation.

Expenditures incurred for development of export markets were to get a weighted deduction at a uniform rate of 133.3% of the qualifying amount. This weighted deduction, it would be recalled, had been withdrawn in the previous budget. Income tax payers having an assessed income between Rs 10,000 and Rs 12,000 were subjected to a tax liability limited to 70% of the excess over Rs 10,000. The budget reduced this tax liability limit to 30% of the excess over Rs 10,000.

A number of steps were taken in the nature of tax concessions to

help the rural sector. The Agricultural Refinance Corporation was exempted from income tax (just as earlier the Industrial Development Bank of India was enjoying this concession) and was to reduce the tax yield by Rs 10 crores in 1979-80. The Khadi and Village Industries Commission enjoyed exemption from income tax; this concession was now extended to State Khadi and Village Industries Boards also. For the consumer cooperative societies, the limit of tax exempt profits was raised from Rs 20,000 to Rs 40,000. The commercial banks were granted a deduction for bad debts relating to advances made by their rural branches subject to certain limitations. This concession was expected to cost the exchequer Rs 12 crores. Expenditure incurred by companies and cooperative societies on approved programmes for rural development now qualified for deduction in computing their taxable profits. Similar exemptions from income tax were also extended to donations made by taxpayers to approved institutions engaged in imparting training to persons for rural development. The exemption of donations from income tax made to institutions engaged in programmes of rural development was now extended to every tax payer (while before the budget it applied only to those in business or professions). Similar exemptions were granted for donations for scientific research by approved institutions etc. The budget also allowed the deduction of insurance premia paid by federal milk cooperative societies for insuring the cattle belonging to members of the affiliated societies.

The budget also exempted from income tax one-third of the income derived from the business of mushroom growing under controlled conditions, or Rs 10,000 whichever is higher.

Indirect Taxes

As regards indirect taxes, the budget provided for a number of tax concessions to the agricultural sector and a number of additional and new levies for the consumer goods and industrial sector.

The Central excise on fertilisers was reduced by 50% of the existing rates. There was an equivalent reduction in countervailing duties leviable on imported chemical fertilisers. Duty on light duty diesel oil used for pump sets was lowered. The power tillers imported by State Agro-Industries Corporation and the Central Government were also completely exempted from customs duty on the plea that these implements can promote agricultural production of small holdings. The indigenously manufactured power tillers were already exempt from excise duties. There were similar tax concessions directed

to help the rural sector. But the most important concession here was the withdrawal of excise duties, including additional excise duties, on unmanufactured tobacco involving a loss of Rs 121.20 crores to the exchequer.

Duties on life saving drugs were lowered. There were also reductions in duties on mopeds, taxies and auto-rickshaws.

A number of excise duties were revised upwards or adjusted in such a manner that the exchequer expected to get an additional Rs 100 crores of tax revenue. These included excise duties on cosmetics, toilet preparations, air conditioning machinery, stereo hi-fi equipment, higher-priced TV sets, higher-priced radio sets and radiograms, pressure cookers, steel furniture, domestic electric appliances, safes, soap, and other similar items, confectionary items, scooters and cars.

Higher duties on motor spirit, HSD oils and kerosene were expected to bring in Rs 278.95 crores including Rs 55.70 crores by way of customs duties. Additional duties on cigarettes were to fetch Rs 60 crores, matches were estimated to bring in an additional revenue of Rs 8 crores, carpets Rs 1.9 crores and handlooms Rs 10 crores. Special duties of excise at the rate of 5% of basic duties were also to continue. Adjustments in customs duties were to bring in another Rs 129.5 crores. Additional revenue from the revision of Posts and Telegraphs rates were estimated to fetch Rs 48.30 crores.

Similarly, the concession hitherto extended to encourage higher production in selected industries was withdrawn (thus bringing in additional Rs 40 crores). The excise tariff under Item 68 ('Items not Specified Elsewhere') was raised from 5 to 8% *ad valorem* and the exemption limit for small scale industries was reduced from Rs 30 lakhs to Rs 15 lakhs of the value of clearance.

Thus, in the field of direct taxation, the budget provided for an additional net tax revenue of Rs 58.60 crores (out of which the States' share was Rs 12 crores) in addition to Rs 160 crores by way of CDS and Rs 48.30 crores by way of upward revision of Post and Telegraph rates. Indirect taxes were estimated to bring in net tax revenue of Rs 606.14 crores out of which the States were to get Rs 192.99 crores and the Centre, Rs 413.15 crores. The additional revenue of Rs 48.30 crores was to be in addition to the above. Thus, the budget left a gap of Rs 1355 crores to be met by deficit financing.

Comments. We find that the budget for 1979-80 started with the usual objectives which the current needs of the economy and the

social and political philosophy of the government demand. However, in practice, it did not move along the lines indicated. Thus, it brought in a heavy dose of deficit financing over and above repeated doses of heavy deficits in the previous two years. The deficit was likely to exceed the budget estimates for 1979-80 also on account of rising prices, higher salaries and allowances, higher expenses by the States and their dependence upon the Centre and similar other factors. Moreover, the choice of items for indirect taxation was not very judicious. A heavy allround upward revision of duties could be only inflationary. And the excise revision on motor spirit, HSD, oil and kerosene was bound to add to the overall cost of transportation and conveyance.

The Centre, on the other hand, failed to tap the agricultural sector and taxed the non-agricultural sectors heavily. On top of the existing uneven tax burden, this only increased the inequity between the two. Instead of tapping this source, the budget extended further concessions to it in the form of additional subsidies through reduced prices of fertilisers etc. But here, as usual, the budget failed to make a distinction between the poor and the rich farmers. The increased subsidies to agricultural inputs only help the rich farmers who are in a position to pay their share of taxes. Thus the budget did not live up to its promise of taxing those who can pay. Similarly, instead of encouraging savings, it reduced incentives for long-term savings. Taxing of gross receipts of luxury hotels cannot be a substitute for taxing conspicuous consumption or providing incentives for savings. Similarly, the budget failed to provide sufficient incentives for labour-intensive techniques of production and reduction of rural unemployment. The schemes incorporated in the annual budget and the concessions granted to rural sector were designed to help the rural rich rather than stimulate the rural sector in a manner which would promote employment and growth.

BUDGET, 1980-81

With a change of Government at the Centre, only an Interim Budget was presented to Parliament on 11 March 1980. No change in the rates of customs, excise duties or income tax was proposed. Only an exemption from income tax was extended for a period of three years to the residents of Laddakh, as also to statutory bodies, associations and institutions established for promotion of interests of Scheduled Castes and Scheduled Tribes.

THE CENTRAL GOVERNMENT BUDGET FOR 1980-81 (June 1980)

The economic situation on the eve of presenting the budget for 1980-81 (on 18 June 1980) was quite a difficult one and the Government had an uneviable task of achieving a set of contradictory objectives. There was a need to revive the economy and, at the same time, large scale resource mobilisation was required to step up plan investment. Our gross national product had declined in 1979-80 by about 3 per cent with a fall in agricultural production by about 10 per cent and that in industry by about 1 per cent. Severe drought had contributed to the reduction in agricultural output as also in the hydel generation of electricity. The poor performance of coal, power, and railways together with labour and managerial problems in vast segments of the economy had led to a general failure of the economic infrastructure. This had resulted in a fall in the production of major commodities like steel, cement, paper, non-electrical machinery, aluminium and other non-ferrous metals, sugar, cotton-textiles and so on. This was accompanied by a general excess of liquidity to which a budget deficit of Rs 2,700 crores had contributed in the previous year. All this had resulted in an inflationary price rise together with an increased trade deficit amounting to Rs [illegible]232 crores, a decline in foreign exchange reserves as also a reduction in food stocks.

The Government was interested in achieving a price stability which implied an increase in output, an improvement in the working of the infrastructure, encouragement to savings and investment and utilising existing capacity. *The budget, therefore, relied more on revival of the economy than raising the tax rates or extending their coverage.* Additionally, it provided a number of concessions and incentives for encouraging savings, investment, and also small scale and cottage industries.

Major Changes in Direct Taxes

1. Exemption limit for income-tax was raised to Rs 12,000, though nil rate-slab continued to remain Rs 8,000.

2. Rate of surcharge on income-tax was reduced from 20 per cent to 10 per cent.

3. Exemption limit for wealth-tax was raised from Rs 1 lakh to Rs 1.5 lakhs from the assessment year 1980-81 in view of the inflationary rise in prices, though the nil rate slab continued to be Rs 1 lakh.

4. Provisions regarding taxation of Hindu Undivided Families and private trusts were tightened for checking tax evasion.

5. To encourage long-term savings incentives were restored at the pre-1979 budget level. Interest on provident funds was exempted from income taxation.

6. The budget tried to achieve the twin objective of promoting new investment in industry and non-favouring of capital-intensive techniques for reasons of employment. Accordingly, the budget continued the tax holiday in respect of new industrial undertakings, ships and hotels, but in a modified form. The criterion for tax holiday was shifted from 'capital employed' to 'profit'. Also, barring some exceptions, additional depreciation allowance equal to 50 per cent of the normal depreciation on new machinery or plant installed during the new Plan period was allowed.

7. Restrictions on the deductible amount of expenditure on advertisement, publicity and sales promotion were removed.

8. An important provision of this budget was the *revival of the interest tax* on interest earned by scheduled commercial banks after 30 June 1980 This tax was further extended to interest received by larger All-India industrial financial institutions namely IDBI, ICICI, IFCI and IRCI.

9. A levy of 15 per cent on gross receipts of expensive hotels was proposed through a bill to be introduced later in the house.

Major Proposals in Indirect Taxation

In this field the approach was to avoid an unduly heavy burden on any single commodity, to encourage small scale and cottage industries, to encourage industries with significant employment and export potential and to reduce or totally remove duty burden on some articles of common consumption.

1. A special excise duty (from which a number of commodities were exempted) was leviable on all exciseable goods at 1/20th of their basic excise duty. The budget raised the rate of this duty to 1/10th of their basic duty with some exceptions. It also extended the special excise duty on all exempted items with the exception of motor spirit including naptha, kerosene, HSD, LSD, LPG, coal, electricity, matches, vanas-

pati, and goods falling under Tariff Item 68.

2. *Ad valorem* duty on soda ash, caustic soda, starch, and synthetic rubber was raised. Molasses was under Item 68 of the Central Excise Tariff and subject to 8 per cent *ad valorem* duty. The budget converted it to a listed item and subjected it to a specific duty of Rs 30 per ton But the molasses produced in khandsari sugar mills was exempted.

3. Certain sectors of indigenous industry were provided a higher degree of protection. Rates regarding passenger baggage were modified. There were also a few proposals in the nature of rationalisation, clearer definition of certain Central excise tariff items and removal of doubts or difficulties.

4. Small manufacturers of goods falling under item 68 of the Central Excise Tariff, whose capital investment on plant and machinery does not exceed Rs 10 lakhs, became eligible for complete exemption from duty on their first clearance of goods upto Rs 30 lakhs in a financial year. This was subject to the condition that their clearances during the preceding financial year did not exceed Rs 30 lakhs.

5. The budget also tried to improve the competitive position of small manufacturer vis-a-vis the large manufacturer and to widen the entrepreneurial base of our economy. A scheme of excise duty concessions applicable to manufacturers of 70 exciseable commodities under which clearances up to Rs 5 lakhs in value in a year were exempted from duty was in existence. The budget included two more groups of items to this list. At the same time, for all these items, clearance between 5 and 15 lakhs would bear 3/4th of the applicable rate of excise duty. Similarly, small producers of paper board were allowed a concessional rate of duty of 20 per cent *ad valorem* instead of 30 per cent.

6. Having recognized the employment and growth potential of electronics industry, the budget tried to help it through a reduction in customs duty on specified items of capital goods used by the industry and not produced within the country, as also specified raw materials and components. Similarly, duty on TV sets was reduced and license fee on small radio and transistor sets was abolished. Excise duty on indigenously produced components was lowered while ships built in Indian shipyards were completely exempted from excise duty.

7. Import duties on certain inputs were reduced or totally removed.

8. Concessions in the field of numerous goods of common consumption items were provided. Specified life-saving drugs, controlled cloth, cotton and cotton-viscose blend hosiery, cycles and cycle parts, sewing machines were fully exempted from excise duty. Excise duty

was also lowered on pressure cookers, cheap varieties of toilet soap, tooth paste, and vacuum and gas-filled bulbs not exceeding 60 watts. Similarly, diesel engines used for conversion of petrol driven taxis and engines used for powered cycle rickshaws were exempted from excise duty.

The taxation proposals were estimated to yield a sum of Rs 223.22 crores in excise duties and Rs 39.58 crores in customs duties. The budget provided reliefs amounting to Rs 34.75 crores in excise and Rs 7.93 crores in customs duties. The net yield, therefore, was Rs 188.47 crores from central excise and Rs 31.65 crores from customs duties. For the full year, the tax proposals were expected to yield a net revenue of Rs 285.98 crores out of which Rs 58.98 crores were to go to the States leaving a net tax addition of Rs 227.0 crores for the Centre.

Total revenue receipts for 1980-81 were estimated at Rs 12,356 crores, while revenue disbursements were put at Rs 13,310 crores leaving a deficit of Rs 954 crores. Capital receipts were put at Rs 7,694 crores as against capital disbursements of Rs 8,157 crores. Accordingly, the aggregate receipts amounted to Rs 20,050 crores against total disbursements of Rs 21,467 crores leaving an uncovered deficit of Rs 1,417 crores. The detailed figures are shown in the facing table.

It is to be noted that the budget tried to achieve a difficult balancing task. It provided incentives for savings through concessions in direct taxation. Though on account of inflationary rise in prices, there was a need to reduce income tax rates all along the line, such a relief could not be expected for reasons of resource mobilisation. The budget, however, did reduce the rate of surcharge on income-tax from 20 per cent to 10 per cent. Production, especially by employment-oriented small scale manufacturers and of consumption goods used by masses (like the bicycles, sewing machines, electronic goods etc.) was encouraged through a reduction or abolition of excise duties. The budget, however, failed to provide the necessary relief in the field of capital gains tax. The previous budget had withdrawn certain provisions which encouraged reinvestment of capital gains, were providing resources to the tune of Rs 200 crores to the Exchequer, and were helping in curbing the growth of black money. The current budget failed to revive these provisions. It should be remembered that the concept of capital gains loses its meaning in view of inflationary rise in prices. An asset holder may make a fabulous capital gain in terms of money, but he is likely to lose in real purchasing power. A taxation of capital gains in such circumstances often

amounts to taxation of a capital loss.

Prior to the budget, a tax holiday, at the rate of 7.5 per cent of the capital employed, could be claimed for five years. This system was abused by many firms claiming tax holiday on borrowed capital also. The budget sought to make the provision employment-oriented by shifting the base of tax holiday to 'profit'. Such a shift would certainly help the industries with a short gestation period like consumption goods. But for the same reason, the industries with long gestation periods (like cement, paper etc.) would be discouraged.

CENTRAL GOVERNMENT BUDGET, 1980-81

Rs in crores

	1979-80 (RE)	*1980-81 (BE)*	*Budget Proposals*
		Revenue Receipts	
Gross Revenue Receipts	11624.73	12321.84	+285.98
Customs	2814.00	2964.00	+ 24.80
Union Excise Duties	5825.20	6117.13	+147.68
*Corporation Tax	1380.00	1515 00	
Income Tax	1320 00	1426 00	
Estate Duty	13.00	13 00	
Taxes on Wealth	63 00	65.00	
Interest Tax	1.00	0.50	+108.50
Gift Tax	6 25	6.25	
Others	202.28	214 96	+ 5.00
States' Share	3406.02	3598.95	+58.98
Union Excise Duties	2530.20	2655 85	+58.98
Income Tax	864.88	932.20	
Estate Duty	10.94	10 90	
Net Tax Revenue	8218.71	8722.89	+227 00
Non-Tax Revenue	2958 12	3409.87	—4.00
Interest Receipts	1484.67	855.98	
Dividends and Profits	296.60	289.2[illegible]	
Others	1176 85	1264.69	—4.00
Total Revenue Receipts	11176 83	12132.76	+223.00
		Revenue Disbursements	
General Services	6270.66	7118.91	
Interest Payments	2206 23	2597 64	
Defence Services (net)	3010.44	3273.15	
Social and Community Services	791.89	890.72	
Economic Services	2448.43	2448 [illegible]4	
Grants-in-aid and Contributions	2536.55	2851.98	
Total	12047.53	13310.35	

Balance on Revenue Account	—870.70	—954.59
	Capital Receipts	
Loan Recoveries	1584.00	1832.00
Market Loans (net)	1961.29	2499.66
External Loans (net)	530.60	800.22
Loans from I.M.F. Trust Fund	....	540.00
Small Savings	925.00	1100.00
Provident Funds	699.85	745.88
Other Receipts	—253.69	172.43
Total	5447.05	7694.59
	Capital Disbursements	
General Services	310.22	375·57
Social and Community Services	108.06	164.68
Economic Services	2090.73	2466.01
Loans and Advances	4767.61	5150.49
Total	7276.62	8156.75
Balance on Capital Account	—1829.57	—462.16
Overall Balance	—2700.27	—1416.75

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